S. Hrg. 99-201

BROKERED DEPOSITS

HEARING

BEFORE THE

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS
AND CONSUMER AFFAIRS

OF THE

COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

NINETY-NINTH CONGRESS

FIRST SESSION

ON

OVERSIGHT HEARING ON THE BROKERED DEPOSITS MARKET CONCERNING THE BENEFITS, AND ABUSES TO THE ECONOMY, THE CONSUMER, AND THE FEDERAL INSURANCE SYSTEM

JUNE 5, 1985

Printed for the use of the Committee on Banking, Housing, and Urban Affairs

U.S. GOVERNMENT PRINTING OFFICE
50-163 O WASHINGTON : 1985

5241-25

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

JAKE GARN, Utah, *Chairman*

JOHN HEINZ, Pennsylvania
WILLIAM L. ARMSTRONG, Colorado
ALFONSE M. D'AMATO, New York
SLADE GORTON, Washington
MACK MATTINGLY, Georgia
CHIC HECHT, Nevada
PHIL GRAMM, Texas

WILLIAM PROXMIRE, Wisconsin
ALAN CRANSTON, California
DONALD W. RIEGLE, Jr., Michigan
PAUL S. SARBANES, Maryland
CHRISTOPHER J. DODD, Connecticut
ALAN J. DIXON, Illinois
JIM SASSER, Tennessee

M. Danny Wall, *Staff Director*
Kenneth A. McLean, *Minority Staff Director*
Linda Zemke, *Counsel*

Subcommittee on Financial Institutions and Consumer Affairs

SLADE GORTON, Washington, *Chairman*

JAKE GARN, Utah
CHIC HECHT, Nevada
PHIL GRAMM, Texas
ALFONSE M. D'AMATO, New York

PAUL S. SARBANES, Maryland
WILLIAM PROXMIRE, Wisconsin
ALAN CRANSTON, California
CHRISTOPHER J. DODD, Connecticut

John Wills, *Legislative Assistant*
Peter Kinzler, *Legislative Assistant*

CONTENTS

WEDNESDAY, JUNE 5, 1985

Page

- Opening statement of Senator Gorton 1
- Opening statements of:
  - Senator Proxmire 2
  - Senator D'Amato 2

WITNESSES

- William M. Isaac, Chairman, Federal Deposit Insurance Corporation 3
  - Effects of brokered deposits 3
  - Monthly reporting requirement 5
  - Prepared statement 7
    - The changing role of deposit brokerage 8
    - The consequences of excessive use of brokered funds 9
    - The response to the problem 10
    - Legislative alternatives 11
    - The 25 largest suppliers of fully insured brokered deposits to troubled, FDIC-insured banks and thrifts 14
  - Response of Chairman Isaac to testimony on Merrill Lynch and FAIC 15
  - Response to testimony of Chairman Isaac from Goldman, Sachs & Co., Frank P. Smeal, partner and member of the management committee 56
  - Response to written questions of Senator Gorton 42
  - Response to follow-up questions of Senator Gorton 58
  - Response to written questions of Senator Dodd 243
- Edwin J. Gray, Chairman, Federal Home Loan Bank Board 18
  - Problems of brokered funds 18
  - Potential for mischief continues 20
  - Prepared statement 22
    - "The Brokered CD Cake," news clip from the Wall Street Journal 39
  - Response to written questions of Senator Gorton 7
  - Response to written questions of Senator Dodd 246
- Panel discussion:
  - Total brokered deposits 40
  - Listing of names 43
  - Failures overnight 45
  - S. 2851 provisions 46
  - Loss the same in either case 48
  - Definition of a troubled bank 49
  - Failed to cap long-term funds 51
  - Garn-St Germain established far greater parameters 53
- Susan Kelsey, vice president, strategic planning, Dean Witter Financial Services Corp., Sears, Roebuck & Co 62
  - Benefits provided by insured broker deposits 62
  - Sears supports S. 791 63
  - Prepared statement 65
  - Additional written submission for the record 71
- Emanuel Falzon, president, Merrill Lynch Money Markets, Inc 96
  - Merrill Lynch shares concern of abuses 96
  - Individual saver insured market 97
  - No need for restrictive regulations 99
  - Prepared statement 100
    - I. Introduction 100
    - II. Background 101

Page

Emanuel Falzon, president, Merrill Lynch Money Markets, Inc—Continued
  Prepared statement—Continued
    III. The brokered certificate of deposit market 105
    IV. Insurability of brokered deposits 118
    V. Alternatives under consideration 131
    VI. Conclusion 134
    Exhibits:
      I. Total brokered deposits 136
      II. Merrill Lynch corporate credit standards 137
      III. American Banker reprints 138
      IV. Comparison of FHLBB and Merrill Lynch 143
      V. Merrill Lynch insured CD outstandings 144
      VI. Reprints of Barnard reports 145
      VII. "Analysis of 1984 Commercial Bank and Savings & Loans Failures" 168
      VIII. Brokered deposits: Legislative alternatives 192
Jorge Coloma, president, FAIC Securities, Inc 196
  Benefits of insured deposit brokerage 196
  Attempt of reconciliation 197
  Prepared statement 199
  Response to query regarding the dollar volume of brokered deposits placed in closed banks by FAIC Securities, Miami Fla 239
Bill Goldsmith, executive vice president, Professional Asset Securities, Inc 210
  Banks fail for three reasons 210
  Flexibility to provide for small banks and thrifts 212
  Suggestions for legislation 213
  Prepared statement 215
Panel discussion:
  Approximately 100 failures in 1984 230
  Analysis on potential CD insurers 231
  80 percent are long term 233
  FAIC does 95 percent of its business with S&L's 235
  Markets move in two directions 237

ADDITIONAL MATERIAL SUPPLIED FOR THE RECORD

Comptroller of the Currency, response to Senator Gorton request for views on broker deposits to supplement information received at the June 5, 1985 hearing, from Michael A. Mancusi, Acting Comptroller of the Currency 248

BROKERED DEPOSITS

WEDNESDAY, JUNE 5, 1985

U.S. SENATE, COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS, SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER AFFAIRS,
Washington, DC.

The subcommittee met at 9:30 a.m., in room SD-538, Dirksen Office Building; Senator Slade Gorton (chairman of the subcommittee) presiding.

Present: Senators Gorton, Hecht, D'Amato, Proxmire, Cranston, and Dodd.

OPENING STATEMENT OF SENATOR GORTON

Senator **GORTON**. The purpose of this hearing is oversight on the issue of brokered deposits. This is an issue which apparently will not go away. Last year the Senate enacted an omnibus banking bill which included a provision affecting brokered deposits, and I expect that a brokered deposits title will also be a feature of a bill this year.

It is unfortunate that on an issue of such apparent significance there is so little agreement over the proper course of regulation. The original rule proposed by your two agencies over a year ago was notable for the controversy it engendered. Then, after weeks of worrying over the issue, last year's Senate bill contained a provision that Mr. Isaac characterized before this committee a few weeks ago as "worse than no bill at all." Already we have seen that proposal reintroduced in the Senate by Senators Mattingly and D'Amato; while two entirely different measures have been introduced in the House by Mr. Wylie and Mr. Garcia.

It may be that the failure to reach an agreement on this issue reflects the absence of good data on the problem. I am dismayed at the apparent difficulty of getting ready answers to some of the most straightforward questions about the extent of the brokered funds problem. And I wonder how any positions can be so strongly held in the absence of clear supporting data. I hope we can clear up some of that today.

It may also be, however, that our failure to agree on a solution is because we do not agree on what the problem is, whether we should seek a quick fix to the immediate problem of exposure of the insurance funds or whether we should look at this problem in the broader context of overall reform of the Federal Deposit Insurance System. Is the question simply one of circumscribing a practice which threatens to lead to large insurance fund payouts, or do we need to rethink the entire question of the purpose of deposit insurance?

I look forward to hearing the testimony of all of the witnesses today, and I thank them for appearing on what is relatively short notice.

Senator Proxmire.

OPENING STATEMENT OF SENATOR PROXMIRE

Senator PROXMIRE. Thank you very much, Mr. Chairman. I understand that this may be Mr. Isaac's last appearance before the committee. He has done a fine job and I regret that he is leaving. I hope he will go to greener pastures. At any rate we will miss you, and I want to thank you very, very much.

I want to point out that one of the reasons we don't have more Senators here is because we were in session last night until 1:30 in the morning. By the time people got home, got to bed, it was probably 2 a.m., 2:30 or 3 a.m. So that is one of the reasons why we don't have the kind of turnout this distinguished duo merits.

Senator GORTON. Thank you.

I understand there are several other members who will have opening statements and we will include them in the record at this point.

OPENING STATEMENT OF SENATOR D'AMATO

Senator D'AMATO. Mr. Chairman, good morning. Today we will examine the effect of deposit brokerage on the financial services industry. Before we start, I would like to commend you on the fine job you have done in conducting this important set of hearings. I also would like to thank the panel of witnesses now before us. I realize the busy schedule these gentlemen have, and I appreciate their taking time from their schedules to testify before this committee.

It was a little more than a year ago when the controversy over deposit insurance for brokered deposits came to the forefront. At that time, Senator Mattingly and I introduced S. 2679, which was incorporated in its entirety into S. 2851, the omnibus banking legislation which the Senate approved in September.

Since, the bill was never acted upon by the House, we are back again this year, reintroducing the legislation as S. 791. This bill would prohibit depository institutions from accepting brokered funds in excess of (1) 15 percent of the bank's total deposits, or (2) 200 percent of the bank's unimpaired capital and surplus.

The issue was originally brought to a head when the FDIC and the Federal Home Loan Bank Board attempted to cut off deposit insurance for brokered deposits. Both the Federal Reserve Bank of New York and the House Government Operations Committee conducted independent reviews of brokered funds which refute any claims that brokered deposits were the root of certain thrift failures.

While there are some problems with unrestricted brokerage, for the most part these can be eliminated with minor reform. Those who charge brokered money with the failures of depository institutions overemphasize the dangers and fail to recognize the virtues of the brokerage function. Brokerage improves the efficiency of the market and, if allowed to flourish, will contribute to bank and thrift institutions ability to provide credit to borrowers.

This hearing is important in that it provides needed insight in a sector of the financial services industry that requires some fine tuning.

Thank you, Mr. Chairman.

Senator GORTON. Senator Hecht, do you have an opening statement?

Senator HECHT. It was a late night last night. No statement.

Senator GORTON. Mr. Isaac.

STATEMENT OF WILLIAM M. ISAAC, CHAIRMAN, FEDERAL DEPOSIT INSURANCE CORPORATION

Mr. ISAAC. Thank you, Mr. Chairman; thank you, Mr. Proxmire, for your kind words.

We appreciate this opportunity to address the issue of brokered deposits and to emphasize its importance to the FDIC.

I won't be giving you my complete statement at this time, but I would like to request that it be included in the record.

Senator GORTON. It will be included in the record at this point.

Mr. ISAAC. As you know, for sometime now the FDIC has been quite concerned about brokered deposits. I cannot overstate the case. Fully insured brokered deposits represent a clear and present threat to the Federal Deposit Insurance System.

EFFECTS OF BROKERED DEPOSITS

For the past 2 or 3 years fully insured brokered deposits have been utilized as a major funding source and have been found in an alarming number of failed banks. During the 1982–84 period, for example, 69 of the FDIC-insured banks that failed held over $1 billion in fully insured brokered deposits. In two instances the brokered funds represented more than 75 percent of the closed banks' deposits. The use of brokered funds by these institutions cost the FDIC hundreds of millions of dollars in additional losses.

Our Division of Bank Supervision recently completed a survey of all FDIC-insured banks and thrifts rated 3, 4, and 5, the lowest categories on our capital assets management earnings liquidity [CAMEL] rating system, which had fully insured brokered deposits in excess of 5 percent of their deposits. We were interested in looking at a number of aspects and specifically sought to determine who supplied these funds and how each of the troubled institutions was utilizing the FDIC-insured brokered deposits.

We were able to identify more than $2.3 billion in fully insured brokered deposits placed in more than 70 troubled institutions. The brokered funds ranged from just over 5 percent to almost 50 percent of the sampled institutions' deposits. In one instance a major brokerage firm in less than a week placed $60 million in new funds in an FDIC-insured savings bank, which used the funds to speculate in high-yield junk bonds.

The exhibit attached to my statement identifies the 25 largest suppliers of fully insured brokered deposits to these weak and risky banks and thrifts. You will note that some of the Nation's largest financial services organizations are heavily involved in funneling fully insured investment moneys to such institutions. The Merrill Lynch and Dean Witter organizations were responsible for placing several million dollars each, substantially increasing the FDIC's exposure to loss.

Keep in mind that this survey occurred after nearly 2 years of intense efforts by the FDIC to control this clear abuse of the Federal Deposit Insurance System. It is frightening to contemplate how much more massive the problem might have become in the absence of these efforts.

Who are the investors? Credit unions were identified as the largest single aggregate dollar holders, followed by commercial banks and savings and loan associations.

It is a simple fact that troubled banks and thrifts use brokered funds more frequently and more extensively than well rated institutions. These institutions tend to pay the highest rates, and brokered funds flow to the highest bidders. Another earlier survey conducted by the FDIC last year showed that out of a total of $24 billion in both insured and uninsured brokered funds held by all FDIC-insured institutions, more than $9 billion was held by those rated 3, 4, and 5. Our studies have revealed that troubled banks are twice as likely as all banks as a group to hold significant amounts of brokered funds.

Banks and thrifts can now market fully insured certificate of deposit [CD's] through brokerage houses to reach a nationwide pool of potential customers. An institution's strength or weaknesses are of little concern: With deposit brokerage, bank risk does not translate into investor risk. The investor merely has to look to the FDIC for repayment if something goes wrong. How many other enterprises in the United States have their money market borrowings backed by the Federal Government in this fashion? Clearly, this is not what Congress intended when it crafted the Federal Deposit Insurance System more than 50 years ago to protect the life savings of working men and women.

The FDIC has addressed these issues by regulation and in individual cases by use of our supervisory and enforcement powers. We issued a regulation limiting Federal Deposit Insurance coverage for all deposits placed by or through brokers to $100,000 per broker per insured institution. As you are aware, however, our 1984 joint effort with the Federal Home Loan Bank Board to accomplish this was challenged in the courts. The ensuing uncertainty about insurance protection has had some effect in limiting the use of brokered funds for now.

We have also dealt with the problems resulting from brokered deposits use on a case-by-case basis. When abuses are found we use our enforcement powers to guard against further deterioration. For nearly 2 years now as a matter of routine we have inserted a provision in all enforcement actions taken against 3, 4, and 5 rated institutions prohibiting further usage of brokered funds. While our vigorous enforcement activities have had a limiting effect on brokered deposits use, I would stress that these actions are not preventive measures. They are of necessity initiated after the fact when problems and clear abuse have already been identified.

MONTHLY REPORTING REQUIREMENT

In January of this year, after an interim testing period, the FDIC instituted a monthly reporting requirement for all FDIC-insured banks and thrifts holding fully insured brokered and financial institution deposits in excess of either the institution's capital or 5 percent of deposits. This reporting requirement provides more frequent and meaningful information than had been available, and increases our effectiveness in dealing with the problems. Institutions reporting heavy usage of brokered funds are targeted for much more frequent inspections, as are those that show up on deposit listing services as paying above normal interest rates.

We recently began publicly disclosing the names of financial institutions placing funds in failed banks and thrifts. Our aim is to focus attention on the fact that brokered and financial institution deposits are all too often placed in institutions offering the highest rates without regard for the safety and soundness of the issuing institution. The point must be driven home that when these institutions fail the cost to the deposit insurance fund is greatly increased.

All these measures have helped, but they cannot be expected to solve the problems. In an environment in which a bank or thrift may purchase a massive volume of funding overnight an institution can radically and precipitously alter its character and its risk to the insurance fund.

We have received virtually no help from the Congress during the past 2 years as we have struggled to contain this serious threat to our insurance system. A subcommittee in the House issued two so-called studies contending that there is no problem despite overwhelming evidence to the contrary. Last year the Senate passed a bill that would have literally tied both hands behind our backs.

Mr. Chairman, members of the subcommittee, we would prefer a good, strong bill to help us in our efforts to preserve our insurance fund. If you can deliver it, we will be extremely grateful; if you cannot, we urge you to do nothing. Please do not add to our burdens by giving us another bill like last year's Senate bill.

The FDIC's joint regulation with the Federal Home Loan Bank Board to limit deposit insurance coverage of brokered funds is, in our view, the simplest and by far the most preferable alternative for dealing with the brokered deposit problem. It does not permit any bank or thrift from using brokered funds or any broker from placing funds. There is absolutely no interference with the functioning of the marketplace. Funds will flow only to those institutions with a balance sheet strong enough to inspire investor confidence. The validity of this regulation should be affirmed by the Congress and coupled with a law denying deposit insurance coverage to credit unions, banks, and S&L's placing their excess funds directly in other insured institutions.

Though the brokerage houses would like to portray themselves as champions of the free enterprise system, they are steadfastly opposed to this market-oriented approach. They would prefer that we regulate the flow of funds through a law placing a cap on the amount of brokered deposits any institution may receive. While we do not like it, we can accept such a bill so long as the cap is reasonable and so long as the law does not in any way impinge on our current authority to prohibit the use of any brokered funds by any troubled institution.

No bank or thrift should be able to leverage upon the Federal guarantee with insured brokered deposits in a volume greater than that which its owners have at risk. The cap for insured brokered deposits should thus be limited to 100 percent of an institution's capital. When you consider that FDIC-insured institutions currently hold $24 billion in both insured and uninsured brokered funds and that a limit of 100 percent of capital would allow nearly $190 billion in fully insured brokered funds alone, this limit is more than generous and ought to satisfy the fee-generating appetite of the brokerage industry for years to come.

The limit must apply to any deposits placed by or through brokers regardless of the term of maturity. Some suggest that longer term brokered funds, those with maturities of 1 year or more, ought to be of less concern to the FDIC because they represent a more stable funding source to a depository institution than to short-term funds. There is absolutely no justification for a distinction between long-term and short-term brokered deposits. Maturity is not the relevant problem. Fully insured brokered deposits of any maturity provide almost limitless funds to a bank or thrift which can be misused without risk to the broker or investor.

I would point out that the bulk of the funds supplied to troubled banks by the Merrill Lynch and Dean Witter organizations have a maturity in excess of 1 year. How much more do these brokers need than a ceiling of $190 billion for FDIC-insured banks and thrifts, not to mention FSLIC-insured institutions, a ceiling that will likely grow by 8 to 10 percent per year as capital increases, a ceiling that is nearly 8 times greater than the amount of all brokered funds, insured and uninsured, in these insititutions today, a ceiling that is over 10 times the size of the FDIC insurance fund?

Thank you once again, Chairman Gorton and members of the subcommittee, for giving us this opportunity to express our views on an issue of great importance to the Nation's financial system. I will be pleased to respond to any questions you might have.

[The complete prepared statement and response to Merrill Lynch and FAIC follow:]

STATEMENT ON
BROKERED DEPOSITS AND FEDERAL DEPOSIT INSURANCE

PRESENTED TO

SUBCOMMITTEE ON
FINANCIAL INSTITUTIONS AND CONSUMER AFFAIRS
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
UNITED STATES SENATE

BY

WILLIAM M. ISAAC
CHAIRMAN
FEDERAL DEPOSIT INSURANCE CORPORATION

JUNE 5, 1985
DIRKSEN SENATE OFFICE BUILDING
ROOM 538
9:30 a.m.

Mr. Chairman, we appreciate this opportunity to address the issue of brokered deposits and to emphasize its importance to the FDIC. As you know, for some time now the FDIC has been quite concerned about brokered deposits. I cannot overstate the case. Fully insured brokered deposits represent a clear and present threat to the federal deposit insurance system.

Let me first make it clear that the FDIC is not against the use of brokered deposits or the practice of deposit brokerage, *per se*. We do not seek to deny brokered funds to any sound institution that uses them prudently in the normal course of business. What we object to are money market investment decisions predicated exclusively on the existence of a full federal deposit insurance guarantee rather than on a proper credit analysis of the bank or thrift borrowing the funds.

The Changing Role of Deposit Brokerage

Money brokering is not a new phenomenon. Brokers have performed an intermediation function for a number of years, matching investors with financial institutions seeking funds. Over the last decade, however, the nature of the money brokers' role has changed dramatically. This transformation resulted from the convergence of a number of economic factors and trends -- most notably a growing sophistication on the part of investors, advances in technology, a volatile and changing economic environment and the impact of the deregulation movement.

In the mid-1970s, when interest rates first reached a double digit level, increased numbers of investors actively began searching for the highest return and altered many of their historical patterns. Money brokers became a more common medium to all investors. By the 1980s, many brokerage firms had essentially become mass marketers stressing the advantages they could offer investors who were intent solely upon maximizing their return at a time of economic volatility. Deregulation of interest rates accelerated this trend as banks and thrifts were permitted to bid freely for funds.

The highly publicized failure of the Penn Square Bank, N.A. in July 1982 -- the largest insured depositor payoff in the FDIC's history -- also had a major effect on deposit brokering practices. Its collapse and the FDIC's handling of it through a payoff rather than a supervisory merger resulted in large depositors with uninsured balances not receiving immediate settlement.

This event could have restored an element of market discipline to our financial system, and to some extent it did, by reminding large investors of the need to look beyond the promises of a high yield to the underlying strength of the financial institution in which they invest. Unfortunately, many deposit brokers and their investor clients responded by splitting funds in order to obtain full federal deposit insurance protection.

We are now faced with a situation where deposit brokerage is being utilized for the purpose of obtaining the highest available risk-free return on investment funds. The cost of that federal guarantee of risk-free return is not borne by the deposit brokers or their investor clients, but is shared by every well-run insured bank and thrift through the increased cost of deposit insurance, higher deposit interest rates and/or lost business opportunities.

The Consequences of Excessive Use of Brokered Funds

Since Penn Square, fully insured brokered deposits have been utilized as a major funding source and have been found in an alarming number of failed banks. During the 1982-84 period, for example, 69 of the FDIC-insured banks that failed held over $1 billion in fully insured brokered deposits; in two instances, the brokered funds represented more than 75 percent of the closed bank's deposits. The use of brokered funds by these institutions cost the FDIC hundreds of millions of dollars in additional losses.

Our Division of Bank Supervision recently completed a survey (data as of February 28) of all FDIC-insured banks and thrifts rated 3, 4 and 5 -- the lowest categories on our CAMEL rating system -- which had fully insured brokered deposits in excess of five percent of their deposits. We were interested in looking at a number of aspects and specifically sought to determine who supplied these funds and how each of the troubled institutions was utilizing the FDIC-insured brokered deposits.

We were able to identify more than $2.3 billion in fully insured brokered deposits placed in more than 70 troubled institutions. The brokered funds ranged from just over five percent to almost 50 percent of the sampled institutions' deposits. In one instance a major brokerage firm, in less than a week, placed $60 million in new funds in an FDIC-insured savings bank, which used the funds to speculate in high yield, corporate (so-called "junk") bonds.

The attached exhibit identifies the 25 largest suppliers of fully insured brokered deposits to these weak and risky banks and thrifts. You will note that some of the nation's largest financial services organizations are heavily involved in funneling fully insured investment monies to such institutions. The Merrill Lynch and Dean Witter organizations were responsible for placing several hundred million dollars each, substantially increasing the FDIC's exposure to loss.

Keep in mind that this survey occurred after nearly two years of intense efforts by the FDIC to control this clear abuse of the deposit insurance system. It is frightening to contemplate how much more massive the problem might have become in the absence of these efforts.

Who are the investors? Credit unions were identified as the largest single aggregate dollar holders, followed by commercial banks and savings and loan associations.

It is a simple fact that troubled banks and thrifts use brokered funds more frequently and more extensively than well-rated institutions. These institutions tend to pay the highest rates, and brokered funds flow to the highest bidders. Another earlier survey conducted by the FDIC showed that out of a total of $24 billion in both insured and uninsured brokered funds held by all FDIC-insured institutions, more than $9 billion was held by those rated 3, 4 and 5. Our studies have revealed that troubled banks are twice as likely as all banks as a group to hold significant amounts of insured brokered funds.

Banks and thrifts can now market fully insured CDs through brokerage houses to reach a nationwide pool of potential customers. An institution's strengths or weaknesses are of little concern -- with deposit brokerage, bank risk does not translate into investor risk. The investor merely has to look to the FDIC for repayment if something goes wrong. How many other business enterprises in the United States have their money market borrowings backed by the federal government in this fashion? Clearly, this is not what Congress intended when it crafted the deposit insurance system more than 50 years ago to protect the life savings of working men and women.

The Response to the Problem

The FDIC has addressed these issues by regulation and, in individual cases, by use of our supervisory and enforcement powers. We issued a regulation limiting federal deposit insurance coverage for all deposits placed by or through brokers to $100,000 per broker, per insured institution. As you are aware, however, our 1984 joint effort with the Federal Home Loan Bank Board to accomplish this was challenged in the courts. The ensuing uncertainty about insurance protection has had some effect in limiting the use of brokered funds -- for now.

We have also dealt with the problems resulting from brokered deposit use on a case-by-case basis. When abuses are found, we use our enforcement powers to guard against further deterioration. For nearly two years now, as a matter of routine, we have inserted a provision in all enforcement actions taken against 3, 4 and 5 rated institutions prohibiting further usage of brokered funds. While our vigorous enforcement activities have had a limiting effect on brokered deposit use, I would stress that these actions are not preventive measures. They are, of necessity, initiated after the fact when problems and clear abuse have been identified.

In January of this year, after an interim testing period, the FDIC instituted a monthly reporting requirement for all FDIC-insured banks and thrifts holding fully insured brokered and financial institution deposits in excess of either the institution's capital or five percent of deposits. This reporting requirement provides more frequent and meaningful information than had been available, and increases our effectiveness in dealing with the problems. Institutions reporting heavy usage of brokered funds are targeted for much more frequent inspections, as are those that show up on deposit listing services as paying above normal interest rates.

We recently began publicly disclosing the names of financial institutions placing funds in failed banks and thrifts. Our aim is to focus attention on the fact that brokered and financial institution deposits are all too often placed in institutions offering the highest rates, without regard for the safety and soundness of the issuing institution. The point must be driven home that when these institutions fail, the cost to the deposit insurance fund is greatly increased.

All these measures have helped, but they cannot be expected to solve the problems. In an environment in which a bank or thrift may purchase a massive volume of funding overnight, an institution can radically and precipitously alter its character and its risk to the insurance fund.

Legislative Alternatives

We have received virtually no help from the Congress during the past two years as we have struggled to contain this serious threat to the insurance system. A subcommittee in the House issued two "studies" contending there is no problem despite overwhelming facts to the contrary. Last year the Senate passed a bill that would have literally tied both hands behind our back.

Mr. Chairman, members of the subcommittee, we would prefer a good, strong bill to help us in our efforts to preserve our insurance fund. If you can deliver it, we will be extremely grateful. If you cannot, we urge you to do nothing. Please do not add to our burdens by giving us another bill like last year's Senate bill.

The FDIC's joint regulation with the FHLBB to limit deposit insurance coverage of brokered funds is, in our view, the simplest and by far the most preferable alternative for dealing with the brokered deposit problem. It does not prohibit any bank or thrift from using brokered funds or any broker from placing funds; there is absolutely no interference with the functioning of the marketplace. Funds will flow only to those institutions with a balance sheet strong enough to inspire investor confidence. The validity of this regulation should be affirmed by the Congress and coupled with a law denying deposit insurance coverage to credit unions, banks and S&Ls placing their excess funds directly in other insured institutions.

Though the brokerage houses like to portray themselves as champions of the free-enterprise system, they are steadfastly opposed to this market-oriented approach. They would prefer that we regulate the flow of funds through a law placing a cap on the amount of brokered deposits any institution may receive. While we do not like it, we can accept such a bill so long as the cap is reasonable and so long as the law does not in any way impinge on our current authority to prohibit the use of any brokered funds by any troubled institution.

No bank or thrift should be able to leverage upon the federal guarantee with insured brokered deposits in a volume greater than that which its owners have at risk. The cap for insured brokered deposits should thus be limited to 100 percent of an institution's capital. When you consider that FDIC-insured institutions currently hold $24 billion in both insured and uninsured brokered funds and that a limit of 100 percent of capital would allow nearly $190 billion in fully insured brokered funds alone, this limit is more than generous and ought to satisfy the fee-generating appetite of the brokerage industry for years to come.

The limit must apply to any deposits placed by or through brokers regardless of the term or maturity. Some suggest that longer-term brokered funds -- those with maturities of one year or more -- ought to be of less concern to the FDIC because they represent a more stable funding source to a depository institution than do short-term funds. There is absolutely no justification for a distinction between long-term and short-term brokered deposits. Maturity is not the relevant problem. Fully insured brokered deposits of any maturity provide almost limitless funds to a bank or thrift which can be misused without risk to the broker or investor. I would point out that the bulk of the funds supplied to troubled banks by the Merrill Lynch and Dean Witter organizations have a maturity in excess of one year. How much more do these brokers need than a ceiling of $190 billion for FDIC-insured banks and thrifts, not to mention FSLIC-insured institutions? A ceiling that will likely grow by 8-to-10 percent per year as capital increases. A ceiling that is nearly eight times greater than the amount of all brokered funds, insured and uninsured, in these institutions today. A ceiling that is over 10 times the size of the FDIC's insurance fund!

Thank you once again Chairman Gorton and members of this subcommittee for giving us this opportunity to express our views on an issue of great importance to the nation's financial system. I will be pleased to respond to any questions you may have.

* * * * *

THE 25 LARGEST SUPPLIERS OF FULLY INSURED BROKERED DEPOSITS TO TROUBLED, FDIC-INSURED BANKS AND THRIFTS

*(Based upon available survey data as of February 28, 1985)

1.	Merrill Lynch	$771,268,000
2.	Dean Witter Reynolds Inc.	447,000,000
3.	Prudential Bache Securities, Inc.	131,406,000
4.	The First Boston Company	115,500,000
5.	Goldman Sachs & Company	80,000,000
6.	Professional Asset Securities, Del Mar, California	63,979,000
7.	FAIC Securities, Inc., Miami, Florida	44,395,000
8.	First Empire Funding Corp., Huntington, N.Y.	43,564,000
9.	The Calvert Group	41,665,000
10.	A.G. Becker	38,000,000
11.	Golconda Financial, South El Monte, California	31,650,000
12.	Shearson Lehman/American Express	28,700.000
13.	First United Fund LTD, Garden City, N.Y.	28,100,000
14.	Paine Webber	27,003,000
15.	Salomon Brothers	26,000,000
16.	Jessup Group, Westport, Connecticut	26,000,000
17.	MKI Money Markets, Inc., N.Y., N.Y.	20,000,000
18.	Harvey Baskin (CDX), Washington, D.C.	19,593,000
19.	Long Beach Savings & Loan Association, Long Beach, California	14,555,000
20.	TCD National, Inc., Encino, California	14,500,000
21.	Churchill, Burbank, California	14,300,000
22.	Continental Money Markets, Inc., San Mateo, California	12,248,000
23.	Morgan Stanley International	10,000,000
24.	Garvin Guy Butler Corporation, San Francisco, California	10,000,000
25.	TCS Funds Brokerage	9,298,000

---

* The survey was limited to troubled institutions holding 5% or more of their deposits in fully insured brokered funds and excluded direct placements by other insured banks, thrifts and credit unions.

FEDERAL DEPOSIT INSURANCE CORPORATION, Washington D C 20429

OFFICE OF THE CHAIRMAN

June 5, 1985

Honorable Slade Gorton
Chairman
Subcommittee on Financial Institutions and
 Consumer Affairs
Committee on Banking, Housing and Urban Affairs
United States Senate
513 Hart Senate Office Building
Washington, D. C. 20510

Dear Mr. Chairman:

Let me again commend you for your hearings on brokered deposits. It gave us the first real opportunity to put this important issue in proper perspective from the regulatory standpoint.

Mr. Chairman, I understand that several incorrect assertions were made during the testimony of the money brokers that I would like to correct for the record.

The Merrill-Lynch representative stated that while they did have a very large sum of money in the First National Bank of Midland, Midland, Texas, the bank did not, in fact, fail. That assertion is incorrect. The First National Bank of Midland was closed on October 14, 1983 by the Acting Comptroller of the Currency. The end result is that the FDIC expects to lose several hundred million dollars on this failure.

The FAIC representative indicated that I was incorrect in stating that FAIC has been consistently involved in banks that closed over the last several years. The fact is they have been very much involved. Our records show that FAIC had fully insured brokered deposits in 11 failed banks during 1984 alone (a list showing the 11 banks is enclosed).

Again, the opportunity you afforded us to be heard on the brokered deposit issue is greatly appreciated. Please include this letter in the official record.

Sincerely yours,

William M. Isaac
Chairman

Enclosure

cc: Honorable Jake Garn
Honorable Chic Hecht
Honorable Phil Gramm
Honorable Alfonse M. D'Amato
Honorable Paul S. Sarbanes
Honorable William Proxmire
Honorable Alan Cranston
Honorable Christopher J. Dodd

BROKERED FUNDS SUPPLIED BY FAIC SECURITIES TO FAILED BANKS

DATE CLOSED	BANK NAME/ADDRESS
12-20-84	The Farmers State Bank Seldon, Kansas
6-18-84	Republic Bank of Kansas City Kansas City, Missouri
6-1-84	Garden Grove Community Bank Garden Grove, California
5-18-84	Bank of Irvine Irvine, California
5-11-84	First Continental Bank and Trust Company Del City, Oklahoma
5-8-84	The National Bank of Carmel Carmel, California
4-27-84	West Coast Bank Los Angeles (Encino), California
4-6-84	Watauta Valley Bank Elizabethton, Tennessee
3-16-84	Seminole State National Bank Seminole, Texas
3-16-84	Heritage Bank Anaheim, California
3-2-84	All American National Bank Virginia Gardens (Miami) Florida

Senator GORTON. Thank you, Mr. Isaac.
Mr. Gray.

STATEMENT OF EDWIN J. GRAY, CHAIRMAN, FEDERAL HOME LOAN BANK BOARD

Mr. GRAY. Thank you very much, Mr. Chairman and distinguished members of the subcommittee.

On behalf of the Federal Home Loan Bank Board I am pleased to once again present my views on the use of brokered funds by FSLIC-insured institutions.

Before summarizing my remarks, which are in the statement which I made available yesterday to the subcommittee, I would like to respectfully ask that an editorial which appeared in the Wall Street Journal on March 28, 1984, entitled "The Brokerage CD Cake," which was supportive of the actions taken by the FDIC and FSLIC, be entered into the record of this hearing.

Senator GORTON. Without objection, it will be so included.

PROBLEMS OF BROKERED FUNDS

Mr. GRAY. My concerns regarding brokered funds date back to the fall of 1983 when it became clear to me that their growing use by savings institutions was out of control and that they were the single-most important factor in a rising number of thrift institution failures.

One of the main reasons for my alarm at the time was that the unlimited use of federally insured third-party brokered deposits was fueling skyrocketing asset growth and that the failures we were beginning to see at the time derived in large part from bad assets. When an institution fails and bad assets are involved the cost to the FSLIC to resolve such cases is far greater than in cases where the cause of insolvency results from earnings spread problems.

As you know, the Bank Board joined with the FDIC in a concurrent rulemaking process to deal with the brokered funds problem and both agencies adopted a final regulation in March 1984, which I continue to believe was crafted to appropriately deal with the problem.

However, the Federal judiciary determined that both agencies had exceeded their statutory authority in adopting the regulation.

The Bank Board on two separate occasions has asked the Congress for authority to classify insurance of accounts. These requests took the form of proposed legislation which was introduced by request last year in both Houses and has been introduced again this year by Chairmen Garn and St Germain at the Board's request.

The ability to classify insurance of accounts would provide the Bank Board, in its capacity as operating head of the FSLIC, the flexibility to deal effectively with the brokered funds problem.

I recognize that there are very powerful financial forces in the lobbying community, some investment banking houses and other money brokering operations, which have sought to prevail on Members of the Congress in their own corporate interest and, frankly, in my view, against the interests of a safe and sound Federal Deposit Insurance System.

Employing their financial might in an effort to run roughshod over the deep concerns of those of us who as surrogates of the Congress are mandated by law to manage and protect the reserves of the Federal Deposit Insurance System, they have succeeded in at least muddying the waters and successfully leaving the impression in some quarters that brokered funds have played no possible role in the failures that we have encountered.

Indeed, these money brokering operations have sought to leave the impression in too many instances that such money brokerage has wrought no harm on the Federal Deposit Insurance System at all. Those at fault, they say, were not the money brokers, but rather insured institutions which invested the funds poorly. The money brokers and the brokered funds, they claim, were simply innocent bystanders, harmless participants in the death dance of failed and failing institutions.

Those who believe such stories are like to believe in fairy tales.

The fact is, in far too many cases it was the easy, instantaneous access to very willing money brokers, willing to provide high-priced federally insured money to any institution which sought it, in virtually unlimited amounts, which fueled the rapidly made investments and loans that have become very bad assets in some of the most significant thrift failures we have seen.

And who was left to pick up the pieces? Members of this subcommittee, your Federal Deposit Insurance System.

I know there are those who don't appreciate hearing what I have just said, but so far as I'm concerned it's the simple truth of the matter, and in all honesty it has increased the strains on your Federal Deposit Insurance System for savings institutions.

I have cited in my prepared statement a number of cases to illustrate the egregious involvement of brokered funds in failed and very troubled FSLIC-insured institutions. Over 50 percent of the most troublesome of the FSLIC's current problem cases involve high levels of brokered funds. The cases I cite in my statement indicate how easy it is to access brokered funds. The risk of loss associated with the high rate of return on acquired assets which have been so often fueled by brokered funds has all too often turned into actual losses and, indeed, huge losses.

In the final analysis, the risks so often fueled by instant access to high levels of brokered deposits are borne not by management or by owners of these insitutions, but by the FSLIC. In these failures and others, as well as other yet unresolved and very difficult cases before us, the easy access to very heavy use of high-priced federally insured brokered funds did not occur in a vacuum, nor could it have been accompanied by purely innocent naivete on the part of the money brokers. To suggest that this kind of money supply operation was or is the equivalent of a simple service performed by request and nothing more ignores the aggressive marketing of such funds to thrift institutions by money brokers. The money brokers were, and are, always held harmless from any risk of loss. The funds were, and are, guaranteed by the FSLIC, and the losses these institutions suffer are borne by the FSLIC.

Fortunately, the efforts made by the FDIC and the Bank Board to rein in these activities, even though the concurrent regulation which was adopted by both agencies was ultimately ruled inoperative by the courts, did have a somewhat chilling effect on money brokering.

POTENTIAL FOR MISCHIEF CONTINUES

Still, the heart of the problem and its potential for further mischief continues. That is why I want to urge the Congress to provide to those of us who are asked to manage these deposit insurance funds the flexibility we need to deal effectively with federally insured money brokering by enabling us to classify insurance of accounts.

I want to make it very clear that I have no problem whatsoever with money brokering as such. It is the use of Federal Deposit Insurance to guarantee funds which can be instantaneously accessed by still healthy or relatively healthy institutions and then invested with no knowledge whatsoever by the regulator in endeavors which may quickly turn very sour, push the institutions into deep trouble fairly rapidly, and cause the funeral bill to the FSLIC to be sky high which concerns me.

What we need today at the Bank Board is the ability to better manage the risk of loss to the FSLIC. What we need is the additional flexibility to do so. What we need is the kind of discretionary elbow room which would allow us to classify insurance of accounts and to place the kind of limits we believe are appropriate to protect the safety and soundness of the insurance fund.

This issue goes beyond just the brokered funds issue. Hasn't the time come for the Congress to reaffirm that the real purpose of the insurance system is to protect the small, relatively unsophisticated saver and to assure that saver's confidence in the financial system; and that the insurance of an account is an agency function, not a wide open playing field subject to twisting and bending by huge, sophisticated or clever financial giants.

The reason the Bank Board worked so closely with the FDIC in moving forward the concurrent regulation on brokered funds last year was because we felt then, and I still believe, thrifts and banks ought to be treated in the very same manner with respect to federally insured third-party money brokering.

I continue to believe that so far as third-party money brokering of federally insured accounts is concerned all banks and thrifts ought to be treated in the same way and that the FDIC and FSLIC should govern through regulatory discretion under law the manner in which these same kinds of insured accounts are treated.

Again, the best way to accomplish the objective of flexibility for both of these deposit insurance funds is to legislatively provide us with the ability to classify insurance of accounts.

This ability would allow us to deal not just with brokered accounts issues but with others that we are beginning to see. For example, some institutions recently began issuing accounts the return on which is tied to the return on an equal investment by the insured institution in pools of real estate investments.

While the Board dealt with that issue on a regulatory basis to define the difference between an insured account and a real estate investment, which the FSLIC was never intended to insure, in my view, ingenious minds are continuing to generate new proposals seeking to clothe various kinds of securities and risk investments with the backing of Federal deposit insurance. Providing the FSLIC explicit statutory authority to determine what kinds of accounts are insured and what kinds are not insured would enable the Bank Board to bring clarity and sanity to this area.

Regulating for safety and soundness to safeguard the resources of our Federal deposit insurance funds is not easy. It demands judgment and flexibility as provided under law. It also demands integrity, firmness, and a full-fledged commitment to uphold the spirit and intent of the law.

I believe this is the principal reason why the Congress has established the independence of the Federal deposit insurance agencies. This independence serves, and has served, this Nation very well for a long time now. We are not interested in protecting the corporate self-interest of any lobbying giant when it comes to the Federal Deposit Insurance System, but we are interested in, and we are committed to, the task of protecting and safeguarding the safety and soundness of our deposit insurance system and the reserves of the system in your behalf and in behalf of the American public and in the interests of a sound and stable depository institutions system in our country.

Flexibility under the law to accomplish these objectives is what I believe we need, and it is my hope the Congress will agree.

Thank you very much.

[The complete prepared statement follows:]

STATEMENT OF
EDWIN J. GRAY, CHAIRMAN
FEDERAL HOME LOAN BANK BOARD
BEFORE THE SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER AFFAIRS
OF THE
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
UNITED STATES SENATE

JUNE 5, 1985

Mr. Chairman and distinguished members of the Subcommittee:

On behalf of the Federal Home Loan Bank Board, I am pleased to once again present my views on the use of brokered funds by FSLIC-insured institutions.

My concerns regarding brokered funds date back to the fall of 1983 when it became clear to me that their growing use by savings institutions was out of control, and that they were the single most important factor in a rising number of thrift institution failures.

One of the main reasons for my alarm at the time was that the unlimited use of federally-insured, third-party brokered deposits was fueling skyrocketing asset growth, and that the failures we were beginning to see at the time derived in large part from bad assets. When an institution fails and bad assets are involved, the cost to the FSLIC to resolve such cases is far greater than in cases where the cause of insolvency results from earnings spread problems.

As you know, the Bank Board joined with the FDIC in a concurrent rulemaking process to deal with the brokered funds problem and both agencies adopted a final regulation in March of 1984 which I continue to believe was crafted to appropriately deal with the problem.

However, the federal judiciary determined that both agencies had exceeded their statutory authority in adopting the regulation.

The Bank Board on two separate occasions has asked the Congress for authority to classify insurance of accounts. These requests took the form of proposed legislation which was introduced by request last year in both houses and again, this year, has been introduced by request by Chairmen Garn and St Germain.

The ability to classify insurance of accounts would provide the Bank Board, in its capacity as operating head of the FSLIC, the flexibility to deal effectively with the brokered funds problem.

I recognize there are very powerful financial forces in the lobbying community -- some investment banking houses and other money brokering operations -- which have sought to prevail on members of the Congress in their own corporate interest and, frankly, against the interests of a safe and sound federal deposit insurance system.

Employing their powerful financial might in an effort to run roughshod over the deep concerns of those of us who, as surrogates for the Congress, are mandated by law to manage and protect the reserves of the federal deposit insurance system, they have succeeded in at least muddying the waters and successfully leaving the impression in some quarters that brokered funds have played no possible role in the failures we have encountered.

Indeed, these money brokering operations have sought to leave the impression in too many instances that such money brokerage has wrought no harm on the deposit insurance system at all. Those at fault, they say, were not the money brokers but rather insured institutions which invested the funds poorly. The money brokers and the brokered funds, they claim, were simply innocent bystanders, harmless participants in the death dance of failed and failing institutions.

Those who believe such stories are likely to believe in fairy tales.

The fact is, in far too many cases, it was the easy, instantaneous access to very willing money brokers, willing to provide high-priced federally-insured money to any institution which sought it, in virtually unlimited amounts, which fueled the rapidly made investments and loans that have turned out as very bad assets in some of the most significant thrift failures we have seen.

Who was left to pick up the pieces? Your federal deposit insurance system.

I know there are those who don't appreciate hearing what I have just said, but so far as I'm concerned it's the simple truth of the matter.

And, in all honesty, it has increased the strains on your federal deposit insurance system for savings institutions.

I need only cite a few failures to illustrate the egregious involvement of brokered funds in failed and very troubled FSLIC-insured institutions.

The first institution I will cite had 1982 year-end assets of $820 million. Assets more than doubled, to $1.90 billion, in the following year and shot up to almost $3 billion by the end of 1984. This 262 percent growth in assets in just two years was fueled largely by brokered deposits. These brokered funds reached a level of a billion dollars in the institution and much of the $2.1 billion growth it fed was in high-risk investments, primarily construction loans and real estate investments. Nonearning assets totalled $720 million by the end of 1984 driving the institution into insolvency.

Perhaps the most widely recognized case of brokered funds was that of Empire Savings and Loan Association of Mesquite, Texas. This state chartered, federally-insured savings institution grew exceedingly fast in a period of two years, and then collapsed under the weight of what we believe were reckless and fraudulent practices. In March 1982, Empire had only $20.7 million in assets, $5.7 million in "jumbo" certificates of deposits, and $8.3 million in outstanding construction loans. By January 1983, Empire had grown to $117 million in assets, $88 million in jumbo CDs, and $50 million in construction loans outstanding. These figures virtually exploded by January 1984, when Empire's assets had grown to $320 million. At the time Empire was placed into receivership in March 1984, brokered deposits of $262 million represented some 85% of total deposits. The skyrocketing growth which led to ultimate disaster for the institution and the FSLIC was fueled in great part by high-priced brokered funds which financed fraudulent real estate transactions and speculative construction in massive amounts.

In another failure, that of San Marino Savings in California, the institution grew from $24 million in assets as of December 31, 1981 to $681 million by year end 1983. The association relied to a large extent on brokered funds to achieve its astronomical rate of growth. The June 1983 semi-annual report reflected that over 50% of savings were originated by money brokers. When the institution was placed into a conservatorship in February 1984, $168 million in brokered funds represented some 43.1% of total deposits. The institution made major construction loans and financed investor-owned condominium conversion units which are considered to be high risk activities. This failure will be very expensive to the FSLIC when all the bills are finally paid.

Over 50 percent of the most troublesome of the FSLIC's current problem cases involve high levels of brokered funds.

Here are some examples:

An institution doubled in size by taking in high-rate brokered deposits and the funds were expended in improperly documented and risky loans which resulted in heavy losses. Internal controls were woefully inadequate.

An institution, which virtually doubled in size in a very short time, employed high-rate brokered money to fund development projects. Appraisals were based on "land-flips" and consequently exaggerated the value of the collateral by several times its actual worth.

Another institution saw growth as a key to restructuring a low-yield portfolio. Brokered deposits funded a rapid quadrupling in size. The high risk assets acquired with the brokered funds turned out to be big losers for the association and, ultimately, for the FSLIC.

Yet another institution became involved in a "linked" financing arrangement with a deposit broker. Not only did the broker deliver high rate deposits, he provided uses for the funds in the form of speculative loans to real estate development projects across the country. When the developers defaulted on the loans, the association was left with the greatly overvalued collateral and, therefore, huge losses.

The stories become very repetitive. Brokered funds are easy to come by, so very, very easy. The risk of loss associated with the high rate of return on the acquired assets -- which have been so often fueled by brokered funds -- has all too often turned into actual losses, huge losses. In the final analysis, the risks so often fueled by instant access to high levels of brokered deposits are borne not by management or by owners, but by the FSLIC.

In these failures, and others, as well as other yet unresolved and very difficult cases still before us, the easy access to, and very heavy use, of high-priced federally-insured brokered funds did not occur in a vacuum nor could it have been accompanied by purely innocent naivete on the part of the money brokers. To suggest that this kind of money supply operation was, or is, the equivalent of a simple service performed by request, and nothing more, ignores the aggressive marketing of such funds to thrift institutions by money brokers in general. The money brokers were, and are, always held harmless from any risk of loss. The funds were, and are, guaranteed by the FSLIC, and the losses these institutions suffer are borne by the FSLIC.

Fortunately, the efforts made by the FDIC and the Bank Board to rein in these activities -- even though the concurrent regulation which was adopted by both agencies was ultimately ruled inoperative by the courts -- did have a somewhat chilling effect on money brokering.

Still, the heart of the problem and its potential for further mischief continues. And, that is why I want to take this opportunity once again to urge the Congress to provide to those of us who are asked to manage these deposit insurance funds the flexibility we need to deal effectively with federally-insured money brokering by enabling us to classify insurance of accounts.

There are those -- particularly in the third-party money brokerage industry -- who would have you believe that the main purpose of federal deposit insurance is to insure accounts. They choose to make that erroneous argument frequently because it serves their own purposes. For if it could be successfully argued that insurance of accounts was the main reason for federal deposit insurance then it might logically be argued that such insurance ought not to be the sole province of depository institutions.

Federal deposit insurance in this country evolved principally as a Congressional response to a series of crises dating back to 1864, 1907, and ultimately to the great depression of the 1930s. The early years of that depression proved that other mechanisms which had been used to maintain stability and prevent loss of depositor confidence were not working.

The financial panic of the early 30s made this clear. Massive runs on banks, indeed the virtual collapse of the banking system, prompted President Roosevelt to proclaim a bank holiday during which all financial institutions suspended operations.

The emergency produced the Banking Act of 1933. This legislation began the process of restoring public confidence in depository institutions by, first, requiring all federally chartered banks to become members of the newly-created FDIC. Subsequently, the Congress passed the National Housing Act of 1934 which established the FSLIC.

President Roosevelt summed up his May 14, 1934, message to the Congress urging passage of the legislation which established the FSLIC in these words:

"These (savings) institutions are custodians of funds for small savers, and it is essential that they should be given every protection. Insurance of this type is necessary in order to arrest any further drain on these institutions and to put them in a position to resume their normal operations."

These concerns were echoed by members of Congress and the then-General Counsel of the Federal Home Loan Bank Board, Horace Russell. In January, 1934, he stated:

"The object to be accomplished by the suggested insurance of savings and loan shares is primarily to stabilize confidence in home financing institutions and thereby attract savings in this direction..."

The fact is, fifty years ago, the Congress specifically assigned to our savings institutions and banks the custodianship of federal deposit insurance. Such insurance has never, ever -- either implicitly or explicitly -- been assigned to any other kind of financial organization by the Congress.

Through the decades which have come and gone since then, depository institutions have accepted their responsibilities as regulated institutions to serve the deposit and lending needs of working men and women, families, the elderly and the young in their communities -- backed by the federal deposit insurance system, which, again, has served to maintain public confidence in the safety and stability of our depository institutions.

Indeed, several years ago, when interest rates reached historic highs and when a chorus of fears echoed through the halls of Congress that there might be panic-generated depositor runs on troubled thrift institutions and banks, the Congress, in overwhelming concurrence, declared by resolution that the "full faith and credit" of the United States would stand behind the federal deposit insurance funds.

While the nature of the action was different, the purpose was the same as that of a Congress a half century earlier -- to reinforce once again public confidence in the stability of our depository institutions as safe havens for the deposits of small savers.

I want to make it very clear that I have no problem whatsoever with money brokering, as such. It is the use of federal deposit insurance to guarantee funds which can be instantaneously accessed by still healthy or relatively healthy institutions and then invested, with no knowledge whatsoever by the regulator, in endeavors which may quickly turn very sour, get the insured institutions into deep trouble fairly rapidly, and cause the bill to the FSLIC for the funeral to be sky-high, which concerns me.

The Bank Board's concerns about money brokering funds to thrift institutions are not new. They go back many years. Indeed, it was only in 1980 that the Bank Board removed the limits on the amount of brokered funds a thrift could take.

Until that time, FSLIC-insured institutions were limited to five percent of deposits in such brokered monies. Indeed, the main reason why the Bank Board took off the five percent limit in 1980 was because the primary concern -- the siphoning of funds in 1959 to invest in California institutions at an advantageous differential -- no longer existed. At that time, federally-insured thrifts were losing deposits to money market mutual funds which were able to pay higher interest because they, unlike depositories, were not subject to federally-imposed rate controls. The attempt to slow the disintermediation which was occurring at the time in many thrift institutions prompted the removal of the five percent-of-deposits limit on brokered funds.

That was understandable, perhaps, under the circumstances. Those circumstances don't really exist today in the thrift industry, and for a number of reasons.

First, the rate control environment which existed then has long since gone. Today, thrifts and banks can pay any rates they choose for funds. There is no lack of liquidity in the industry.

Second, the Bank Board has been operating for a year now with a regulation which limits brokered funds to five percent of deposits for savings institutions which fail to meet a snapshot three percent net worth level, unless waived by the Bank Board in a particular case for very good cause.

Third, in January, the Bank Board adopted a new regulation which far more closely correlates asset growth to net worth and will have, we believe, the effect of substantially slowing new asset growth, especially in the absence of commensurate earnings on that growth.

However, the new net worth regulation must be reviewed within its two year sunset period and it is important that the Board have the flexibility to consider not only the amount but the type of deposit growth undertaken by an insured institution.

What we need today at the Bank Board is the ability to better manage the risk of loss to the FSLIC. What we need is additional flexibility to do so. What we need is the kind of discretionary elbow room which would allow us to classify insurance of accounts and to place the kind of limits we believe are appropriate to protect the safety and soundness of our insurance fund.

This issue goes beyond just the brokered funds issue. Hasn't the time come for the Congress to reaffirm that the real purpose of the insurance system is to protect the small, relatively unsophisticated saver and to assure that saver's confidence in the financial system; that the insurance of an account is an agency function -- not a wide open playing field subject to twisting and bending by huge, sophisticated or clever financial giants.

The reason the Bank Board worked so closely with the FDIC in moving forward the concurrent regulation on brokered funds last year was because we felt then, and I still believe, thrifts and banks ought to be treated in the very same manner with respect to federally-insured third party money brokering.

I continue to believe that so far as third-party money brokering of federally-insured accounts is concerned, all banks and thrifts ought to be treated in the same way and that the FDIC and FSLIC should govern through regulatory discretion under law the manner in which these same kinds of insured accounts are treated.

Both the FDIC and the FSLIC currently have the ability to set percentage limits on the share of insured brokered funds institutions they regulate can accept. At the FSLIC, that would include all FSLIC-insured institutions. At the FDIC, it would only include those state-chartered non-Federal Reserve member banks which the FDIC also regulates. This would not include Federal Reserve member banks and national banks because their primary regulators would not be subject to any such FDIC-established percentage limits.

Hence, in my view, the need to permit the FDIC and FSLIC to establish such percentage limits they may deem to be appropriate, given the responsibilities of these federal insurance corporations to safeguard the resources of their funds. Again, the best way to accomplish the objective of flexibility for both of these deposit insurance funds is to legislatively provide us the ability to classify insurance of accounts.

This ability would allow us to deal not just with brokered accounts issues but with others that we are beginning to see. For example some institutions recently began issuing accounts the return on which is tied to the return on an equal investment by the insured institution in pools of real estate investments.

While the Board dealt with that issue on a regulatory basis to define the difference between an insured account and a real estate investment -- which FSLIC was never intended to insure -- ingenious minds are continuing to generate new proposals seeking to clothe various kinds of securities and risk investments with the backing of federal deposit insurance. Providing the FSLIC explicit statutory authority to determine what kinds of accounts are insured, and what kinds are not insured, would enable the Bank Board to bring clarity and sanity to this area.

The next best way would be to impose a five percent limit, as a percentage of total insured deposits, on all third-party, federally-insured brokered funds placed at any federally-insured depository. I would permit the insurance corporations the discretion to allow an institution to exceed that limit only in very exceptional cases where, in the insurer's view, the national interest would justify it.

In my view, legislatively determining what is an appropriate maturity for any money-brokering, insured certificate of deposit would undercut what I believe ought to be properly left to the discretion of the appropriate insurance corporation.

I want to return here to an earlier concern I expressed: that an intense lobbying effort by a powerful money broker industry lobby intent on causing explicit legislation to be passed governing the exact manner in which the Presidentially-nominated and Senate-confirmed boards of governors of the FDIC and FSLIC are to treat federally-insured brokered funds, would, if successful, simply undercut the discretion and flexibility we need to manage for safety and soundness the resources of, and respond to changing circumstances of, these insurance funds.

What we need, I believe, is the support of the Congress in our efforts to safeguard the reserves of the insurance funds under different, changing and, yes, sometimes difficult circumstances. And, of course, we need and fully expect the continuing oversight of the Congress with respect to the manner in which we carry out our duties under the law.

None of this, however, is meant to suggest in any way that the Congress should act or legislate in any way other than that which it deems appropriate. The Congress of the United States, with the President, is charged with the responsibility for making national policy. Our job is to carry out national policy and that we try very hard to do.

Regulating for safety and soundness to safeguard the resources of our federal deposit insurance funds is not easy. It demands judgment and flexibility as provided under law. It also demands integrity, firmness and a full-fledged commitment to uphold the spirit and intent of the law.

I believe this is the principal reason why the Congress has established the "independence" of the federal deposit insurance agencies. This independence serves, and has served, this nation very well for a long time now. We are not interested in protecting the corporate self interest of any lobbying giant when it comes to the federal deposit insurance system.

We are deeply interested in, and we are committed to the task, of protecting and safeguarding the safety and soundness of our deposit and insurance system and the reserves of the system, on your behalf, in behalf of the American public, and in the interest of a sound and stable depository institutions system in our country.

Needed flexibility under the law to accomplish these objectives is what I believe we need, and it is my hope the Congress will agree.

Thank you very much. I will be happy to try to answer any questions members of the Subcommittee may have.

Federal
Home Loan
Bank
Board

daily news clips

THE WALL STREET JOURNAL
MARCH 28, 1984
Page-32

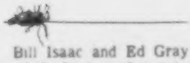
WEDNESDAY, MARCH 28, 1984

1700 G Street, N.W., Washington, D.C. 20552 Telephone (202) 377-6923

A STAFF BRIEFING SERVICE OF THE OFFICE OF COMMUNICATIONS

REVIEW & OUTLOOK

The Brokered CD Cake



Bill Isaac and Ed Gray couldn't stand the heat, so they got out of the kitchen. That was clear from the two regulators' decision Monday to get the government out of the business of fully insuring brokers who put together small chunks of money and buy big certificates of deposit in banks and savings and loans around the country. Mr. Isaac's Federal Deposit Insurance Corp. and Mr. Gray's Federal Home Loan Bank Board decreed that as of Oct. 1 they will insure only up to $100,000 per broker in any institution. The money brokers are faced with an agonizing reappraisal of what has been a flourishing business.

Mr. Isaac and Mr. Gray acted because of their correct belief that federal insurance was creating perverse incentives. Conservative banking types were being tempted to become high-flying financial wheeler-dealers: If a bank flush with brokered CD deposits that it attracted with high interest rates successfully lends or invests the funds in high-return ventures, it wins big; but even if these ventures fail and the bank's assets are effectively wiped out, as they have been recently in areas where energy markets turned sharply downward, the federal insurance funds restore 100% of brokered deposits.

At bottom, we read the Isaac-Gray decision like this: A multibillion-dollar investment business whose principal source of funds is explicitly insured by the federal government is simply beyond the pale of free-market principles. Moreover, this contradiction has been widely if briefly studied and no one has yet come up with an alternative system that is economically and politically salable to all interested parties. That being the case, the two regulators slammed on the brakes. The two men are clearly suggesting that if there's a problem, Congress is going to have to fix it.

We hope the public and private parties might somehow work out a solution that would impose traditional market discipline on the users of brokered CDs. The one the two regulators already have imposed is not bad. The brokers might find that they will have to provide their own insurance and a more intense effort at risk assessment, a process that could have a salutary effect on the depository institutions as well. Big brokers like Merrill Lynch would seem capable of taking care of the policing problem themselves.

What is equally important in our view is that all the players understand clearly the uses and needs of an increasingly sophisticated capital-markets system. Brokered CDs are a direct outgrowth of the federal deregulation of interest rates and the financial system generally. Small investors now have access to the relatively safe, well-paying financial instruments made possible by a national capital-markets system that has become adept at diversifying risk. Moreover, brokered CDs were giving local banking markets the ability to attract funds to compete with the thundering herd of new national financial institutions and money-center banks.

But the brokered-CD controversy raises a fundamental problem that everyone involved in financial deregulation will have to come to terms with eventually: Many people want the banks to start acting like other businesses, but no one is quite willing to let banks fail the way real businesses fail. They want to preserve the public trust created by federal deposit insurance in the 1930s to prevent financial panics, while participating in the profit opportunities that are only possible in a market where some people will flat-out fail.

We went over much the same ground with the money-center banks' LDC debt. It's just fine if you want to try to maximize your returns by lending desperate or starry-eyed governments huge sums at two points over Libor, but doing so in the belief that the U.S. government will prevent or bail out failures is ultimately going to distort the system. Similarly, a system of full federal insurance for brokered CDs was simply too good to be true.

We all have an interest in maintaining public confidence in the integrity and safety of the financial system. The question is whether we should continue to approach new areas, such as brokered CDs or LDC debt, in terms of effectively making the system fail-safe the way we did in the 1930s, or whether we now need to reconsider the role financial failure plays in keeping the larger system healthy and growing. The benefits to the West's advanced industrial and service economies of free and innovative capital markets can't be overstated. But any person, bank or nonbank that wants to ride on the forward wave of those innovations ought to assume the attendant risks of failure.

There should be a place in all this for individual investors and institutions that want to minimize the risk of loss on all or some of their capital, and it's in this area that the federal government may have a role. But short of serving as the lender of last resort, government has no business systematically insuring, guaranteeing or bailing out people in the business of competing for the market's best returns.

Senator GORTON. Thank you, Mr. Gray.

TOTAL BROKERED DEPOSITS

For both of you, what is the total of brokered deposits at FDIC- and FSLIC-insured institutions?

Mr. ISAAC. $24 billion as of last year, Mr. Chairman, in FDIC-insured institutions.

Mr. GRAY. I will provide that for the record.

[The following information was subsequently furnished for the record:]

FSLIC-insured institutions held $43 billion of broker-originated deposits on December 31, 1984. This represented 5.5 percent of total deposits at these institutions.

Senator GORTON. What share of the amount is insured?

Mr. ISAAC. We don't have a very good idea of that. The money brokers increasingly are putting the money in various forms of accounts. It is almost impossible to track the insurance coverage of it. For example, Merrill Lynch and Dean Witter place a lot of money in negotiable CD's, big CD's, and then they participate out the balances of those CD's to various individuals and businesses around the country. And so unless and until a bank fails and we can call in the records, we can't determine the insurance coverage. It is our hope shortly to come out with a regulation—I believe the Bank Board already has one out—that will require the names and addresses of all these customers to be listed on the books and records of the bank so that we will be able to track insurance coverage.

Senator GORTON. So you can't tell me whether it is 40 or 90 percent?

Mr. ISAAC. Not really. There is $9 billion in 3, 4, and 5 rated banks. I find it almost inconceivable that much of that money is uninsured. So I would guess the better part of $9 billion is pretty much fully insured, and then some amounts of the other would be insured.

Senator GORTON. How about all of the failed banks last year? You must have determined what percentage of those.

Mr. ISAAC. Those are all insured. They don't even expose the interest these days. They are putting $94,000 in a failing bank rather than $100,000 because they don't want to take any chance on even the interest being lost.

Senator GORTON. Mr. Gray.

Mr. GRAY. I think the lion's share of the accounts that are in brokered form are certainly FSLIC-insured. I will provide more explicit information.

Senator GORTON. Please do. We would like as explicit information as we can get.

[The following information was subsequently furnished for the record:]

More than one-half (52 percent) of the $43.0 billion of broker-originated deposits at FSLIC-insured institutions at year end 1984 were in deposits fully covered by FSLIC insurance. A portion of the remainder was also covered, of course, because $100,000 of deposits in excess of $100,000 are insured. We have no firm data on this proportion, but information for all large accounts suggests about 42 percent are covered by insurance. Consequently, nearly three-fourths of all broker-originated deposit balances at FSLIC-insured institutions are probably covered by FSLIC insurance.

Senator **Gorton**. Mr. Isaac, you spoke of the $9 billion in the CAMEL rated 3, 4, and 5 banks. How would that break down between long term and short term?

Mr. **Isaac**. I can't tell you for sure. I don't have that number. I could probably provide you with some study. I can tell that approximately 80 percent of the money that Merrill Lynch and Dean Witter have invested in 3, 4, and 5 rated institutions shown in the survey attached to my statement as an exhibit is long term.

Senator **Gorton**. Would that figure be different in FSLIC?

Mr. **Gray**. I would think that it would be more in short-term money at our institutions.

Senator **Gorton**. What share of or how many of FDIC- and FSLIC-insured institutions have significant amounts of brokered funds?

Mr. **Isaac**. There are only approximately 650 FDIC-insured institutions that have any brokered funds.

Senator **Gorton**. Out of how many?

Mr. **Isaac**. Out of 15,000.

Senator **Gorton**. So it would be fewer than 650 who had brokered funds in significant amounts, amounts that would concern you to any degree?

Mr. **Isaac**. There are 650 in total. I don't recall the number that have 5 percent or more. I can get that for you.

Senator **Gorton**. We would like that.

[Information subsequently supplied for the record follows:]

FDIC
Federal Deposit Insurance Corporation
Washington, D.C. 20429

Office of Congressional Relations and Corporate Communications

June 17, 1985

Honorable Slade Gorton
Chairman, Subcommittee on Financial
 Institutions and Consumer Affairs
United States Senate
Washington, D.C. 20510

Dear Senator Gorton:

At the hearing of your Subcommittee on June 5 you asked Chairman Isaac two questions respecting brokered deposits for which he agreed to provide additional information for the record. I am pleased to submit the following information.

Reference was made to a survey which showed $9 billion of brokered funds in troubled banks and the question was asked -- can this amount be broken down into long-term and short-term maturities? The answer is "no" because the figure of $9 billion in brokered funds in troubled banks was obtained from the December 1984 Call Reports and Schedule RC-E, Deposit Liabilities, does not break brokered funds down into any type of a maturity schedule.

Another question -- how many banks have a significant amount of brokered funds? As of June 12, there are 636 banks that have some brokered funds. The April 30, 1985 report, required under Section 304.4 of the FDIC Rules and Regulations, shows 226 banks with brokered deposits that exceeded five percent of the respective total deposits. Ninety-nine of these banks had a composite CAMEL Rating of 3, 4 or 5. Listed below is breakout of ratings for those reporting banks.

	Composite CAMEL Rating	Total Number of Insured Banks
	1	26
	2	86
	3	43
	4	39
	5	17
	* New	15
TOTAL		226

I trust this is responsive to your inquiry.

Sincerely,

Graham T. Northup

Graham T. Northup
Director

*A new bank is a bank without a composite rating or with a composite rating from a state report which the FDIC did not accept.

Mr. ISAAC. There are approximately 650 instititions in total that have any insured brokered funds and over one-third of those are troubled banks.

Mr. GRAY. I will provide that information. But I will say here that over 50 percent of the most troublesome of the FSLIC's current problem cases—let me add, other troublesome cases that have not yet come to the FDIC— involve a high level of brokered funds.

[The following information was subsequently furnished for the record:]

Only 739 of the 3,135 FSLIC-insured institutions (24 percent) held broker-originated deposits on December 31, 1984. Approximately 16 percent of the institutions with such deposits could be considered "troubled."

Senator GORTON. Since January 1 of this year what have the trends been for the number of institutions with brokered deposits and the total amount of insured brokered deposits outstanding? Is it going up? Going down? Or is it relatively steady? I think your chart date is January 1, isn't it?

Mr. ISAAC. I wish I could tell you. We are not really able to sort that out because the data are so poor. We have a feeling that the problem is less serious today than it was 2 years ago, primarily due to all of these efforts that we have made, including the fact that we have an insurance regulation out there that has cast some doubt on coverage.

Senator GORTON. Is that why you say to us do nothing if we don't do it right?

Mr. ISAAC. That is correct. Through various things we have done already and some things we still have up our sleeve, we will try to control this problem if the Congress doesn't interfere.

Senator GORTON. Would that answer apply to you as well, Mr. Gray?

Mr. GRAY. Well, I would say that the somewhat chilling effect of our regulations last year has been salutory. The problem that we are now feeling in full force is the residual effects of what has happened as a result of the tremendous growth, the skyrocketing growth, which was fueled by brokered funds in 1983 and 1984. Most of our biggest and most difficult FSLIC problem institutions have a good share of brokered funds.

I have provided a number of examples, of course, in my statement. They are the most egregious examples of the kinds of problems that we are having where brokered funds were involved. It is very, very expensive for the FSLIC to resolve these cases, if we can resolve them at all without resorting to liquidation.

LISTING OF NAMES

Senator GORTON. Mr. Isaac, you said that while you assumed, at least in troubled institutions, that practically all brokered deposits were insured, that one of your frustrations was that you didn't know and that you hoped to require names to be attached to these deposits in the future. At the present time, in general terms, does the bank, or for that matter, the savings and loan, know how much of its outstanding brokered funds are insured?

Mr. ISAAC. No; the brokers, frequently in contracts with the institution, prohibit the institution from access to the names of the beneficial holders of the negotiable CD's so that the institution itself doesn't even know who the customers are and whether they are insured. But I think we are both going to correct that problem here shortly.

Senator GORTON. By your nodding, I gather you agree with that.

Mr. GRAY. I think he is referring to the regulation that we have proposed and which currently the FDIC is considering proposing which would require that the names and addresses of the parties involved would be provided to the insured institution.

Senator GORTON. How good a substitute for brokered deposits are other types of purchased money, especially repurchase agreements?

Mr. ISAAC. The repurchase agreement is self-limiting. You've got to have an asset to sell that somebody is willing to hold as collateral. Therefore, while repurchase agreements do give an institution access to money, there is a limit on the amount of money that can be raised that way. There is no limit on the amount of money that can be raised through fully insured brokered deposits. Therefore, I find repurchase agreements far less obnoxious than brokered deposits.

Senator GORTON. So it wouldn't bother you if regulation of brokered deposits caused repurchase agreements to be used as a substitute because they are automatically controlled in amount?

Mr. ISAAC. They are collateralized and there is a limit as to how much good collateral there is and how much money can be raised.

Mr. GRAY. Exactly.

Senator GORTON. How good a substitute for the broker network would direct marketing by depository institutions be?

Mr. ISAAC. If you accepted our other proposal, which is to deny deposit insurance coverage to credit unions, banks, and S&L's placing their excess funds in other insured institutions, if you closed down that loophole, I think direct marketing would be a very ineffective substitute for money brokering and that we would have this problem licked.

Mr. GRAY. There is simply not a lack of liquidity in our thrift institution system today. Thrift institutions have been very effective in marketing funds for many years. I believe they continue to be. So that really, insofar as I am concerned, is not a problem.

Senator GORTON. In your case, Mr. Gray, didn't the Maryland privately insured S&L's engage in a great deal of direct marketing of their CD's even outside of Maryland?

Mr. GRAY. I would emphasize here that fast growth fueled by either jumbo deposits or by brokered funds can accomplish the same ends, which are in too many cases disastrous ends.

Mr. ISAAC. I think, Mr. Gorton, that direct marketing, if you cut out the financial institutions, is not going to be very effective for very many institutions. It is very hard to go out of your territory and gather up a lot of deposits. Some can do it, but it is very, very difficult, and it takes a lot of time to get it done. You can't do it overnight like you can with money brokering. With money brokering I can go out and I can double, triple, or quadruple the size of my institution tomorrow. With direct marketing efforts, particularly if you cut out the financial institutions from insurance coverage, it is going to take a long time to develop a network, and the regulators can spot the thing coming and get on top of it before it gets out of control.

Senator GORTON. That leads to a last question. How quickly can large amounts of brokered deposits be garnered and how rapidly can an institution's position deteriorate from satisfactory to troubled?

FAILURES OVERNIGHT

Mr. ISAAC. Overnight. For example, we have an institution—a clearly troubled savings bank, nobody could doubt that it's in trouble, just a cursory look at its financial statements would show that it's a problem institution—and Prudential Bache, one of the leading brokerage firms in the country, came in and in less than 1 week's time put over $60 million in this institution to help it speculate in junk bonds. Is that what deposit insurance was intended to allow?

We had an institution in the Midwest that I can recall that failed last year. It had been in the control of a family for 50 years—a perfectly fine institution, serving its small town. It was 1 or 2 rated at its latest exam, and 3 months later the money brokers came in, duped them into taking these funds, duped them into investing the funds in some wild loans, and the institution was broke. For 50 years this institution had existed and served its community, and thanks to the money brokers the community is now without the bank. The bank doubled or tripled in size virtually overnight.

Senator GORTON. I imagine those owners contributed to that.

Mr. ISAAC. I don't hold the owners blameless. They were not too bright, at the very least. But the access to brokered money is what made it possible. We will undoubtedly sue the owners or the directors and officers of the bank, if we haven't already. But in the meantime the money brokers are off scot-free and they are foisting the money off on other institutions.

Mr. GRAY. Mr. Chairman, the problem is not only the instantaneous access to brokered funds, just picking up the telephone and calling by wire transfer, getting virtually as much money as you want, and the all too rapid investment of that money either in loans or investments, but in too many cases a large upfront fee is secured for the thrift institutions and unfortunately there was poor underwriting of a loan that the institutions had to live with afterward. It is not only this scenario that has caused such grief to us, but in addition we have seen a number of examples, very difficult cases, where the money broker actually established a quid pro quo that the money would be provided only where the money broker could arrange for the investment of those funds. Such practice is not only unseemly, it is perhaps improper.

In any event, we have seen such cases and these activities of the money brokers have brought about the demise of the institution. Clearly, management had substantial responsibility.

But again, the availability instantaneously to any amount of money that you want has made it much more difficult to deal with this, because we have no way of instantaneously keeping track of how money is coming and what it is being invested in. We don't manage these institutions. We only find out later. And unfortunately, in all too many cases we find out when horrendous disasters have occurred.

Senator GORTON. Senator Proxmire.

Senator PROXMIRE. Thank you very much, Mr. Chairman.

This is a fascinating hearing. It is great to have two very able regulators come before the committee and tell Congress that we have been doing a lousy job, which you are doing and doing very effectively, and at the same time raise serious questions about a very distinguished panel that is going to follow you. I wonder what they are going to say in view of the very strong criticism you have been able to deliver here.

Neither of you gentleman leave any doubt as to where you stand. It's excellent testimony. But on page 8 of your statement you say:

> Mr. Chairman, members of the subcommittee, we would prefer a good, strong bill to help us in our efforts to preserve our insurance fund. If you can deliver it, we will be extremely grateful. If you cannot, we urge you to do nothing. Please do not add to our burdens by giving us another bill like last year's Senate bill.

Do you agree with that, Mr. Gray?

Mr. GRAY. I would suggest that the classification of accounts that we have asked for is what we need. That would enable us to have the flexibility we need.

Senator PROXMIRE. No; I asked you if you felt that way about last year's Senate bill.

Mr. GRAY. I felt that last year's Senate bill was totally inadequate and that it did have the effect of tying our hands behind our backs as managers of these insurance funds.

Senator PROXMIRE. So nothing would be better than the kind of bill that we passed last year?

Mr. GRAY. I do not want to be unresponsive to your question. I would hope that the Senate could provide the classification of accounts that we have asked for which would greatly improve our ability to deal with these problems. We have offered that in proposed legislation which was introduced by request last year and this year.

Senator PROXMIRE. On page 4 of your statement, Mr. Gray, you give a vivid example—Empire. You say in March 1982 Empire had only $20.7 million in assets, $5.7 million in jumbo certificates. Then you say by January 1983 that $20 million had gone to $117 million, and that's in only 9 months. And then in the next year, by January 1984, they exploded to $320 million. So in less than 2 years they went from about $20 million to $320 million; increased sixteenfold. Given this huge increase in funds, Empire then made a lot of very bad loans.

You claim that brokered deposit momentum was responsible for this. It seems that it is not rectitude that maintains virtue, but the lack of opportunity.

S. 2851 PROVISIONS

Mr. GRAY. I don't assign total blame to brokered deposits, but I say that the involvement, and the very heavy involvement of brokered funds in that case, certainly was an important factor in the failure of that institution.

Senator PROXMIRE. Let me ask both of you gentlemen this. Suppose the S. 2851 provisions, title 8 on brokered deposits, replaced current regulations? Will outlays by the FDIC and FSLIC be increased over the next 5 years compared to existing regulations?

Mr. ISAAC. Could you repeat that?

Senator PROXMIRE. I will state it again. Supposing the S. 2851 provisions, title 8 on brokered deposits, replaced current regulations. The question is: Will outlays by the FDIC and the FSLIC be increased over the next 5 years compared to existing regulations?

Mr. ISAAC. I gather the bill you are referring to is last year's Senate bill.

Senator PROXMIRE. That's right.

Mr. ISAAC. If that became law and replaced our current efforts would our outlays increase over the next 5 years?

Senator PROXMIRE. That's correct.

Mr. ISAAC. I would be surprised if we have an insurance fund 5 years from now.

Senator PROXMIRE. In other words, it would greatly increase it?

Mr. ISAAC. Greatly, yes.

Senator PROXMIRE. So if we pass title 8 of S. 2851 we will actually be increasing the budget deficit over the baseline; isn't that correct?

Mr. ISAAC. Assuming the Federal Government wants to stand behind the insurance fund, yes.

Senator PROXMIRE. Can you put a dollar figure on that? You say you wouldn't have an insurance fund. I take it that would wipe out the whole thing.

Mr. ISAAC. This problem could have gotten totally out of control by this time had we not done the things we have done in the past 2 years to try to keep it under some kind of reasonable control. The Senate bill last year had two major flaws in it. One, it placed no cap whatsoever on the long-term funds. So that means everybody who is providing short-term funds is simply going to start providing long-term funds. There is no credit risk involved. So why not? So we would have absolutely no control on the amount of funds going into these institutions that are long term in nature.

On the short-term funds the ceiling was too high. And then, to make matters worse, the Senate bill would have taken away our enforcement authority. As long as an institution had a minimum book net worth of 3 percent we wouldn't be able to do anything to run these funds out.

We can't afford that bill. It's just too expensive. It would cost the FDIC hundreds of millions of dollars easily, if not billions of dollars.

I am probably exaggerating when I say our fund would disappear; but it would be incredibly expensive. We lost $100 million in one bank in Puerto Rico last year thanks to Merrill Lynch, Dean Witter, and other brokers, $100 million in one bank. We lost $400 million in First National Bank of Midland thanks to Merrill Lynch and other brokers.

Senator PROXMIRE. On page 5, Mr. Isaac, you say: "Troubled banks and thrifts use brokered funds more frequently and more extensively than well-rated institutions."

Later today we will be hearing from both Merrill Lynch and Dean Witter. I notice on your chart they are way out in front; they are two-thirds of the 25 largest suppliers to troubled FDIC-insured institutions. To what extent have these two organizations been responsible for placing brokered deposits in troubled banks and thrifts?

Mr. ISAAC. They are the leading suppliers. The facts speak for themselves.

Senator PROXMIRE. I take it from your anecdotal data that in some cases these institutions were not in trouble until the brokered deposits came along.

Mr. ISAAC. That is correct.

Senator PROXMIRE. Chairman Isaac, you say in your testimony on page 10, and I quote again, "There is absolutely no justification for a distinction between long-term and short-term brokered deposits." Yet quite a bit of effort has been made by some to distinguish between the two. What is the basis for your statement that they should not be distinguished?

LOSS THE SAME IN EITHER CASE

Mr. ISAAC. In terms of harm to the insurance system, there is no difference between a long-term dollar and a short-term dollar. The fact is, whether it is long-term or short-term, the institution is receiving money that is federally guaranteed; there is no credit risk to the broker and no credit risk to the broker's customer. The funds are placed indiscriminately in the banks and thrifts that pay the highest rates. And I couldn't care less whether it's a long-term dollar or a short-term dollar. The loss to us is the same in either case.

I might point out that as alarming as the figures are—showing Merrill Lynch at $771 million—I have a 1984 survey which showed them at $2.4 billion in troubled banks and thrifts. I am having trouble reconciling the two, I've got to tell you, and I would like to submit supplemental information to you in the weeks ahead. This latest survey showed only deposits that we could identify as fully insured in 3, 4, and 5 rated institutions that held 5 percent or more of their deposits in fully insured brokered deposits. So there were some limits on this latest survey.

The earlier survey just looked at 3, 4, and 5 rated institutions and all of their brokered deposits whether they had 5 percent or more or not, and in that survey Merrill Lynch came out at $2.4 billion.

So I think this latest survey understates the problem.

Senator PROXMIRE. On the other hand, Merrill Lynch claims that they have very careful credit standards and that they don't put deposits in troubled banks.

Mr. ISAAC. That's just plain false. I am not saying they don't have standards, but they placed $250 million or thereabouts in First National Bank of Midland, which failed. It was less than that by the time it failed, but at one point it was close to $250 million. They had upwards of $20 million in the Girod Bank & Trust Co. in Puerto Rico, which was one of the worst excuses for a bank I've ever seen.

Senator PROXMIRE. How about Dean Witter?

Mr. ISAAC. I'll have to go through and see what banks they have their money in. I don't have that before me. To my knowledge, I don't remember Dean Witter being in a failed bank other than Girod.

I am not trying to say Merrill Lynch and Dean Witter are the worst actors. There are others. Some of them are going to testify today.

Senator PROXMIRE. They are the biggest actors.

Mr. ISAAC. They are the biggest actors. There are others. Some of them are going to testify today. FAIC, for example, shows up in a very high percentage of failed banks where there are brokered funds. Where there are brokered funds you can almost bet FAIC is going to be there.

Senator PROXMIRE. Let me just conclude because my time is up. I would appreciate it very much if both you gentlemen could submit in writing proposed legislation where you think we can help the most. I think you have been very helpful in your testimony. But if you could actually draft legislation, and also if you could do it with safeguards recommended to be sure that we can be alert to being lobbied by Merrill Lynch and Dean Witter to tie your hands.[1]

Thank you.

Senator HECHT. May I just ask one question. I have to go vote in another committee.

Senator GORTON. By all means.

Senator HECHT. Just one question for both of you. We have talked at length on the issue of brokered deposits. I support your efforts to bring these under greater control, yet we have heard from advocates of brokered deposits who state that they are a necessary and positive influence. Is it true that brokers provide a useful service in providing liquidity to banks in temporary difficulty?

I would like to hear from both of you on that.

Mr. ISAAC. Let me put it this way. Brokers and their funds are not welcome in troubled banks. We don't want them; we don't need them; we would do almost anything to keep them out of there. If a bank is in trouble and needs liquidity, it should go to the Federal Reserve. That's what the Federal Reserve is for. If it cannot borrow from the Federal Reserve because it is running out of collateral or is insolvent, it is time to close the bank and let the FDIC bring a new bank to the community that can serve the community's needs. We don't want brokered funds in troubled banks, period.

DEFINITION OF A TROUBLED BANK

Senator HECHT. Give me a definition of a troubled bank.

Mr. ISAAC. A bank that is rated 3, 4, or 5 on our CAMEL rating system is a troubled bank. Brokers are not welcome there.

Senator HECHT. My colleague wants to know what 3, 4, or 5 means.

---

[1] Chairmen Isaac and Gray were unable to reach an agreement on the request of Senator Proxmire for proposed legislation in time for publication.

Senator D'AMATO. Put it on the record, Bill. Why don't we get rid of troubled banks? You've got this mental set. Did these banks get in trouble because of brokered deposits?

Mr. ISAAC. All too often, yes.

Senator D'AMATO. For every bank that you can show me that got into trouble because of brokered deposits we can show you 10 that didn't, and it wasn't brokered deposits that brought it about. You have a mind-set that—well, we disagree, and you know we disagree. I want to tell you, look at the facts, and your facts will not substantiate it. The brokered deposits did not bring about the troubles in these banks. That's nonsense.

Mr. ISAAC. Senator D'Amato, I am not here for my health. I didn't take this issue on for my health.

Senator D'AMATO. I'm not here for my health either. What does that mean? What does that mean?

Mr. ISAAC. Why am I here? Why do I care about brokered deposits? It's not because I'm getting any political mileage out of it.

Senator D'AMATO. Do you think I'm getting political mileage?

Mr. ISAAC. No, I didn't say that———

Senator D'AMATO. Did you oppose the legislation that we put in last year that set reasonable requirements? Close the banks that should be closed. If you're not doing the job with the troubled banks, it seems to me that that's the problem.

Mr. ISAAC. Senator D'Amato, we cannot stay on top of the problems with the brokers pumping the money as fast as they are.

Senator D'AMATO. Set reasonable requirements. Do you have some suggestions? Put them up to us. Don't just simply say no brokered deposits.

Mr. ISAAC. We have reasonable requirements, and that is, No. 1, we want to be able to absolutely prohibit any troubled bank from using brokered deposits.

Senator D'AMATO. What's a troubled bank? Don't tell me 3, 4, 5.

Mr. ISAAC. Any bank rated 3, 4, or 5.

Senator D'AMATO. What do we mean by 3, 4, or 5?

Mr. ISAAC. I will be happy to provide you with our definitions. Basically it has to do with the classified assets as a percentage of capital, and also an analysis of their earnings and other factors.

Senator GORTON. Senator Hecht, are you finished?

Senator HECHT. No, I haven't started.

I want to hear Mr. Gray answer the same question.

Mr. GRAY. It has been our experience in our worst cases that all too often money brokers have in fact, as I said before, not been innocent bystanders. They have been very much involved in these problems.

Bill and I may disagree on this, but I think there are extraordinary circumstances, which rarely may occur, where, in the national interest, the insurance agency may at its discretion choose for liquidity purposes, and with very close supervision, to allow an institution to address that problem, as we did in the summer of last year.

Senator HECHT. Thank you.

Senator GORTON. Senator D'Amato.

Senator D'AMATO. Mr. Chairman, first of all, let me commend you for calling these hearings. I think they are important and necessary. I have got another committee meeting as well. It just seems to me that there is a lot of rhetoric taking place attempting to almost place the blame for some of the failures—or not just some—of the troubled banks, the thrifts in particular, on brokered deposits, on junk bonds. Let me suggest to you that if you look at the record—and I would love to have you do an analysis—you're going to find that they are in trouble because of bad portfolios, because of faulty construction loans, because of loans that they have made in other areas. There is much more than is the case with respect to the one or two sensational cases that you might bring out and show where there have been almost scams, and they have been outrageous, and we proposed legislation last year which was passed here in the Senate, which I thought adequately began to address the problem.

I would like your comment on it, because you did say you supported it, with respect to, No. 1, imposing limitations or to how much in the way of brokered deposits could be placed into these institutions. Specifically, we prohibited depository institutions from accepting brokered funds in excess of 15 percent of the bank's total deposits or 200 percent of the bank's unimpaired capital and surplus. Is that a reasonable requirement?

Mr. ISAAC. No.

Mr. GRAY. No.

Mr. ISAAC. I think last year's Senate bill was awful.

Senator D'AMATO. Well, so do I, but for other reasons. I voted against it.

FAILED TO CAP LONG-TERM FUNDS

Mr. ISAAC. This part of it was awful and would be far worse than no bill. You didn't cap long-term funds at all.

Senator D'AMATO. I think the bill was a disaster. We precluded interstate banking, we gave to the banks the rights to get into the securities industry.

Mr. ISAAC. I'm not referring to the other parts of it.

Senator D'AMATO. Well, that's what I was referring to.

Mr. ISAAC. I'm referring to the brokered deposits part of the Senate bill last year. It didn't cap long-term deposits at all.

Senator D'AMATO. What would be a reasonable cap?

Mr. ISAAC. The same as short term. There is no distinction whatsoever. The short-term cap was too high and you took away our authority to deal with troubled banks.

Senator D'AMATO. We took away your authority?

Mr. ISAAC. Yes.

Senator D'AMATO. How did we do that?

Mr. ISAAC. As long as a bank had a minimum book net worth of 3 percent we had no enforcement authority whatsoever under the Senate bill.

Senator D'AMATO. Well, if you can suggest an improvement.

Mr. ISAAC. I have suggested an improvement in my testimony, and that is we should have a cap equal to 100 percent of capital on long- and short-term deposits and we should make sure that the FDIC's current authority to deal with troubled institutions is not in any way interfered with. That ceiling would give the brokerage industry the right to put $190 billion in fully insured brokerage funds into the banking industry. I think that ought to satisfy their appetite for many years to come.

Senator D'AMATO. Are they a bad industry, Mr. Isaac?

Mr. ISAAC. Pardon?

Senator D'AMATO. Is the securities industry a bad industry? Are they an anathema to the system?

Mr. ISAAC. I have a problem with their money brokerage activities. If you go down the list of firms here, Merrill Lynch, Dean Witter, Prudential Bache, Shearson/Lehman, and others on the list, the FDIC has approved applications by them to acquire banks. So I certainly don't have any general problem with those firms. They are good firms and in most of the ways they do business they provide valuable services to the American public. In their insured money brokerage activities, it wouldn't bother me if they discontinued them all tomorrow.

Mr. GRAY. Senator, let me just comment, with all due respect, on your position. As I said in my opening statement, the money brokers claim they were simply innocent bystanders and harmless participants in the death dance of failed and failing institutions. I thought a great deal about the choice of that language because I think it certainly fits the situation. What we have here is a situation where it takes two to tango. In our case—I can't speak for the FDIC—these innocent bystanders and harmless participants were in effect part of the dance that led to horrendous failures. And we haven't seen all of them yet. As I said before, and I don't believe you were here, some 50 percent, in fact over 50 percent, of the most troublesome of the FSLIC's current problem cases involve high levels of brokered funds.

Senator D'AMATO. We could go round and round and I thank the chairman for having called this hearing.

Let me simply suggest that it just seems to me that we have a lot of troubled banks who are in those troubles and have their troubles not as a result of the brokered deposits, not as a result of the so-called junk bonds. We are getting all excited about the question of whether there should be reasonable restraints and requirements, and maybe Mr. Isaac is absolutely correct in terms of a cap. I don't know. I am going to look at it and see. But let's not lay the failure of the banks and the trouble that the 3, 4, and 5's are in specifically on the brokered deposits. That's nonsense, and that's the implication that you give by your testimony. You can say, well, I haven't said that. That's exactly the implication you give. And when there is failure 1, 2, or 3, we shouldn't turn our eyes from it.

Mr. ISAAC. I hope that I have not implied that all the problems in the banking system are due to the money brokers. What I did say in my testimony is that 69 of the banks that have failed in the past 3 years had significant amounts of brokered funds, and in a number of those cases the brokered funds were the cause of the problems; in other cases the brokered funds prolonged the life of the bank and helped escalate the losses.

Senator D'AMATO. They exacerbated it.

Mr. ISAAC. And in some cases we have lost substantial amounts of money directly attributable to brokered funds.

Senator D'AMATO. I have no problem with seeing to it that there are proper safeguards. There is created the illusion that as a result of brokered deposits, their activities, they have created the weakened system. That's not the case. The system has been weakened because of poor portfolios, poor construction loans, the change in the economy, out there with the low-interest money, having to borrow. You're right, there are those who will attempt to stay afloat by paying the highest yields. We understand that, and so that is why I would suggest that we come up with a system which does not imperil the useful activity and the capital that can be generated today as a result of brokered deposits.

Thank you, Mr. Chairman.

Senator HECHT. Mr. Chairman, I had to walk to the Energy Committee for a vote. May I ask one more question?

Senator GORTON. You certainly may.

Senator HECHT. When the Federal Government sets up guidelines for Federal insurance, whether it's to banks, savings and loans, or whatever it might be, and States go beyond and set up additional guidelines, do you think the Federal Government should sit down and say we will no longer give you insurance if you do not follow our Federal guidelines?

GARN-ST GERMAIN ESTABLISHED FAR GREATER PARAMETERS

Mr. GRAY. You may be directing that more to me than to him. Of course, Garn-St Germain, which was passed in late 1982, did establish far greater parameters and elbow room for thrift institutions to engage, for example, in pure commercial lending up to 10 percent of assets, commercial real estate lending to a greater degree. Some of the States certainly have gone well beyond that, and in my own home State of California the difference is incredible as to what those State-chartered institutions can do above and beyond what our federally chartered institutions can do. What we have said is that if the Congress indeed found suitable the limits that it placed, after 2 years of extensive debate and discussion of these powers that provided additional asset authority, that to the extent a State authorized investment beyond what Congress found suitable for Federal deposit insurance for federally chartered thrifts that we ought to be able to charge a risk premium.

I think that is the way to sanely deal and bring rationality to our dual banking, our dual Federal-State thrift system, and I am very, very hopeful, Senator, that this year the Congress and the Senate will look very carefully at that proposal, because I think it is needed; it is critically needed as we move out into the future.

Senator HECHT. Thank you.

That's all, Mr. Chairman.

Senator GORTON. Senator Cranston, do you have an opening statement?

Senator CRANSTON. No; I do not.

Senator GORTON. A query to both of you with respect to H.R. 107. Is there any reason why we should consider limits on uninsured brokered deposits?

Mr. ISAAC. I do not have any reason to put limits on uninsured brokered deposits.

Mr. GRAY. No; I have no problem with money brokering when it does not involve the Federal guarantee and where the Federal Government doesn't have to pick up all the pieces when an institution fails.

Senator GORTON. On that subject, Mr. Falzon, one of our next witnesses, will point out that even your proposed regulation would have been ineffective at preventing the failure of Penn Square Bank because the great bulk of that institution's brokered deposits were uninsured. Is that factually correct? If so, does it weaken the case for your proposals?

Mr. ISAAC. I cannot tell you offhand whether it is factually correct. I think it probably is largely correct. There were a lot of uninsured moneys in Penn Square. There were also a lot of insured moneys. But the broker problem has become so much more severe because of Penn Square. We handled that large failure as a payoff and we stuck some people with a loss. A lot of credit unions, banks, and S&L's got hurt in that one. That really was one of the turning points when this brokerage problem started.

Senator GORTON. What you are saying is that helped trigger the problem.

Mr. ISAAC. That's right. And so now many credit unions, S&L's, and banks around the country are going to money brokers to split their money up. They put it in troubled institutions in $94,000 chunks so that they don't have any principal or interest at risk. If I have $10 million, I go out and I find maybe 100 different institutions that are paying the highest rates. I do that through a money broker; in an instantaneous transaction, and I have nothing at risk. Penn Square is what has helped to fuel this activity. Money brokering started to mushroom after Penn Square.

Senator GORTON. Mr. Gray.

Mr. GRAY. I think that most of the money in our institutions is in fact insured money when it comes to brokers. The lion's share of it is. We have proposed to the Congress in the legislation that you have before you, introduced by request, to require that when we are dealing with a troubled, failing institution and we are transferring the deposits and the assets to the acquirer, assuming we can find one, that we not transfer the uninsured savings accounts, but that they be dealt with afterward when the assets are disposed of. I think that would bring far more discipline to our system.

Senator GORTON. Thank you both. The chairman and I think other members of the committee do have some additional questions. We will submit them to you in writing.

Mr. ISAAC. Thank you, Mr. Chairman, for holding this hearing. I think it is one of the first hearings we have had on this issue in either House, and it has helped to clear the air. The money brokers are asking for a Federal guarantee of a profit; they are trading off the FSLIC and the FDIC symbol. If we want to give them a Federal subsidy, then let's do it out of taxpayer revenues, because we don't have enough money in our insurance funds to hand out that kind of money.

So I really appreciate your giving us this opportunity.

Senator HECHT. Mr. Chairman, I would say we did clear the air this morning.

Senator **Gorton**. I was going to suggest that Mr. Isaac and Mr. Gray, particularly Mr. Isaac, stay and hear themselves and their ideas denounced, if they wished to.

Mr. **Isaac**. Thank you very much.

Mr. **Gray**. Thank you very much.

[Response to written questions of Senator Gorton from Chairman Isaac and Chairman Gray follow:]

[Response to William Isaacs testimony from Frank P. Smeal, general partner, Goldman, Sachs & Co. follows:]

Goldman, Sachs & Co | 85 Broad Street | New York, New York 10004
Tel 212-902-1000

Goldman
Sachs

July 10, 1985

The Honorable Slade Gorton
Chairman of the Subcommittee on Financial Institutions
Senate Committee on Housing, Banking and
Urban Affairs
Room 534
Senator Dirksen Office Building
Washington, D.C. 20510

Dear Senator Gorton:

I am a general partner and a member of the Management Committee of Goldman, Sachs & Co. and am in charge of its Fixed Income Department.

I understand that William Isaacs, the chairman of the Federal Deposit Insurance Corporation, testified before your Subcommittee on June 6, 1985 concerning so-called "brokered deposits". In the course of his testimony, he identified Goldman, Sachs & Co. as one of a number of firms which he alleged engaged in brokering deposits which were fully insured by the FDIC; in the case of Goldman, Sachs & Co., he asserted that we acted as a broker for $80,000,000 of such deposits. Goldman, Sachs & Co. does not engage in the practices alleged by Chairman Isaacs, and I am writing to clarify the record.

Chairman Isaacs testified that certain firms bought certificates of deposit on behalf of customers. These certificates of deposit were issued by banks which were rated by the FDIC as financially troubled;[1] in order that the deposits were fully insured by FDIC, each certificate was then broken up by the broker into deposits of $100,000 or less for each customer. Chairman Isaacs believed that such practices were unwise and put the FDIC's insurance fund unduly at risk.

Regardless of the merits of Chairman Isaacs' views on the such activities, Goldman, Sachs & Co. simply does not engage in them. Goldman Sachs is a major broker/dealer in a wide variety of money market instruments; it is, for example, one of thirty six primary dealers who transact business directly with the Federal Reserve Bank of New York. Bank certificates of deposits are among the instruments in which Goldman Sachs deals. Because the FDIC refuses to advise Goldman Sachs of which banks identified Goldman Sachs as a broker of their deposits, it is impossible for us to determine whether we even purchased certificate of deposits of any such banks. However, assuming that we did so, the amount of any such certificate would have been well in excess of $100,000 and almost certainly in excess of $1,000,000, and any certificates we sold would have been in the same size. We specifically did not and do not break up certificates of deposits into smaller pieces in order that customers benefit from full FDIC insurance. Because the size of the certificates of deposits bought and sold by us were far in excess of the FDIC limits, it is simply incorrect to assert that Goldman Sachs was brokering deposits fully insured by the FDIC. We believe that Goldman Sachs' activities contribute to the financial stability of banks by providing them with a deposit base without unduly affecting FDIC's insurance fund.

---

[1] The FDIC identified banks which were rated 3, 4 or 5 on its reporting system as financially troubled; that methodology is curious in view of the fact that the failure of a bank with a "3" rating is, according to FDIC's rating system, "only a remote possibility". The FDIC does not publicly disclose its ratings of banks.

I find it extremely troubling that Goldman Sachs was falsely accused by the Chairman of a federal regulatory agency of engaging in practices which he believed encouraged unsafe banking practices and exposed the bank insurance fund to undue risk. Such an allegation is particularly objectionable, because it was made without any prior consultation by the FDIC with Goldman Sachs. Indeed we first became aware of such charges when we read them in the financial press.

I trust that this letter has made clear that Goldman Sachs has not engaged in the practices of which Chairman Isaacs complained. We would be grateful if this letter was made part of any record of the proceedings of Subcommittee. If you have any questions concerning Goldman Sachs or its role as a dealer in certificates of deposit, I would be happy to provide you with further details.

Very truly yours,

Frank P. Smeal

cc: The Honorable William M. Issacs ✓

FEDERAL DEPOSIT INSURANCE CORPORATION [illegible]

OFFICE OF THE CHAIRMAN

July 24, 1985

Honorable Slade Gorton
Chairman, Subcommittee on Financial
Institutions and Consumer Affairs
Committee on Banking, Housing, and Urban
Affairs
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

This is in response to your letter of June 14 submitting a number of follow-up questions to my testimony on brokered deposits on June 5. These questions are listed and answered separately in the attached.

With regard to how much of the approximately $9 billion of brokered deposits in troubled banks was short-term versus long-term and how many of the approximately 650 banks with brokered deposits held brokered deposits in excess of five percent of total deposits, these questions were answered earlier in our letter to you dated June 17, a copy of which is also attached for convenient reference.

I also thought you might like to have a copy of my recent testimony on brokered deposits before the Subcommittee on General Oversight and Investigations of the House Committee on Banking, Finance and Urban Affairs. A copy is enclosed.

Sincerely,

William M. Isaac
Chairman

Enclosures

RESPONSE TO WRITTEN QUESTIONS OF SENATOR GORTON FROM CHAIRMAN ISAAC

Attachment

1. A number of observers have suggested that aggressive examination and supervision, coupled with a prohibition on the garnering of insured brokered funds by troubled institutions, is sufficient to solve the problem. Why is this not so, in your view?

Certainly aggressive examination and supervision and a prohibition on the acceptance of insured brokered deposits by troubled institutions are important. We closely monitor all insured banks that utilize insured brokered deposits, and we are engaged in an aggressive examination and supervision program for banks under our jurisdiction. However, this approach tends to be uneven, slow and imposes considerable cost and other burdens on both the regulatory agencies and the affected institutions. Even more importantly, the approach, as well as the suggestion to deny fully insured brokered deposits to troubled institutions, tends to operate after the fact, that is, after a bank has gotten into difficulty. Given the speed with which an insured bank can acquire a very substantial volume of brokered funds, reliance on examinations and supervision alone will never be adequate to the task.

2. What is your evaluation of the two alternative proposals for dealing with brokered deposits contained in this year's H.R. 15 and H.R. 107?

H.R. 15 would limit the acceptance of insured brokered deposits to no more than five percent of average total deposits for the preceding three months and would prohibit the acceptance of any insured brokered deposits by institutions at or below minimum net worth requirements established by the appropriate federal regulatory agency.

H.R. 15 has some merit in that it would tend to slow the acceptance of insured brokered deposits in order to afford the supervisory process a better opportunity to address any developing problems. While helpful, the approach still would allow considerable leeway for abuse and would depend on constant monitoring and supervision. We support the prohibition on the acceptance of insured brokered deposits by institutions below established minimum net worth requirements so long as it is clear that we can also prohibit the use of brokered funds by any troubled institution even if it meets minimum net worth requirements.

H.R. 107 would distinguish between short-term (12 months or less) and long-term brokered deposits. It would prohibit the acceptance of short-term brokered deposits if an insured bank's unimpaired capital and surplus was less than three percent of total liabilities and would otherwise place certain limitations on the acceptance of short-term brokered deposits if a bank's unimpaired capital and surplus was three percent of total liabilities or greater. Long-term brokered deposits would be unaffected.

H.R. 107 is totally unacceptable. It makes no sense whatsoever to distinguish between short- and long-term brokered deposits. Long-term brokered deposits are just as susceptible to abuse as short-term. In a recent case, a major brokerage firm, in less than a week, placed $60 million in new funds in a clearly troubled FDIC-insured savings bank, which used the funds to speculate in high-yield (so-called "junk") bonds. These deposits were placed for terms of three to ten years.

3. You proposed denying deposit insurance to deposits placed by banks, credit unions, and S&Ls. Why stop there? Why not deny it to deposits placed by insurance companies, the federal government, or municipalities? More generally, do you believe that deposit insurance should be available to individuals, but not to institutions?

Banks, credit unions and savings and loan associations are in essentially the same business and should be able to analyze the financial condition of banks in selecting their depositories. Together, these institutions constitute a significant potential source of much needed market discipline. Additionally, these institutions are covered directly by federal insurance programs should events like uncollectible assets cause them to fail. Finally, they are without question the biggest abusers of the deposit insurance system, a system that was created to assist them; we find that unconscionable. We would be pleased to go further or have the authority to go further if Congress wishes us to do so.

4. Mr. Falzon, in his testimony, maintained that brokered deposits placed on behalf of individuals have "not been associated with any of the problems the FDIC and the (FHLBB) have attributed to deposit brokerage." If you have evidence to the contrary, would you submit it for the record, please?

We do not always know whether brokered funds ultimately belong to individuals or to companies. The certificates evidencing these funds are frequently issued in bearer form or in the name of the broker as agent or nominee with no listing of the beneficial owners. With regard to closed banks, we can point to the case of the First National Bank of Midland, Texas, which failed on October 14, 1983. At the time it failed, it held brokered deposits totaling approximately $75 million. It is believed these certificates of deposit were participated out to various individual clients of Merrill Lynch and that the entire amount was fully insured.

With regard to open institutions, the June 7th edition of The Wall Street Journal (copy enclosed) reported an egregious case of a California savings and loan association that acquired $2.5 of its $4 billion in total deposits through brokerage firms and invested $1 billion in high-yield, low-grade so-called "junk" bonds and another $1 billion in unrated investment quality bonds (whatever that means). In addition, last year the institution invested $1 billion in GNMAs in order to speculate on a decline in interest rates. In contrast, the institution originated only $200 million in mortgages last year, which is the business Congress created S&Ls to serve. We believe this case represents a massive abuse of the deposit insurance system, which was never intended to supply federally guaranteed funds to entrepreneurs to enable them to speculate in the securities markets.

We would point out that most if not all of the brokered deposits in this institution were long-term. Though we do not have any information on it, we would not be surprised to learn that these funds were supplied by major houses such as Merrill Lynch and Dean Witter. We believe it would be extremely useful and informative if the Subcommittee were to request from these two investment houses and others a list of all institutions (FDIC- or FSLIC-insured) with which they are placing funds, showing the rates of interest and maturities.

There is no reason in logic why the funds of individuals would not be involved in the abuses associated with the brokerage of fully insured deposits. From the point of view of the individual investor, it matters not what use is made of his or her funds or what may be the condition of the institution in which the funds are placed since he or she is protected in any event by the federal insurance guarantee. From the point of view of the financial institution, a dollar for investment purposes made available through a broker is the same whether the source is an individual or an institution. Aggregating the generally smaller lots of individual investors is a simple matter in this age of computers.

5. To what time period do the figures you submitted in the table accompanying your written statement pertain? Are they for a single date in time, or do they cover a period of time; and if so, do they overstate the amount of brokered deposits placed at any one point in time? In addition, could you add a column to this table, showing how much of the total placed by each brokerage firm had been in CAMEL rated 3, 4, or 5 institutions?

The figures in the table accompanying the written statement are as of the close of business on February 26, 1985. The table shows only total brokered funds placed in 3-, 4- and 5-rated banks.

We are reluctant to breakdown how much of the brokered deposits placed by each brokerage firm was in each individual rating band because that information, in many instances, would reveal the CAMEL ratings of the institutions. Of the total of $2.1 billion in fully insured brokered deposits placed by all 25 of the firms listed, some $348 million or 16.6 percent was placed in 3-rated institutions; $1.7 billion or 82.8 percent was placed in 4-rated institutions; and $12 million or 0.6 percent was placed in 5-rated institutions.

6. In December of 1984 the FDIC adopted a regulation, effective January 1985, which requires each insured bank with fully insured brokered deposits plus fully insured deposits placed by depository institutions exceeding a threshold amount to report various data to the FDIC. Would you supply the Subcommittee with tabulations of these data, showing for each of several bank size classes (i.e., under $100 million in total assets, $100 million to $1 billion, over $1 billion; or such alternative grouping as is convenient), how many such institutions are required to report; how many of these are CAMEL rated 3, 4, or 5; and for this latter group the average (both mean and median) percentage of total deposits represented by these two types of deposits, as well as the breakdown of the total between the two types of deposits?

As of March 31, 1985, a total of 227 insured banks reported. Of these, 177 held total assets under $100 million, 33 held total assets between $100 million and $1 billion, and 17 held total assets over $1 billion. We do not disclose CAMEL ratings by size of bank. However, of the 227 that reported, 100 were CAMEL rated 3, 4 or 5. These 100 banks reported fully insured brokered deposits totaling $2.6 billion and fully insured deposits placed by other depository institutions totaling $0.4 billion. The total of these two categories of deposits in relation to total deposits in the 100 banks represented a mean of 9.1 percent and a median of 9.0 percent.

7. Based on your experience with failed institutions, to what degree are short-term brokered deposits owned by individuals; and to what degree are long-term brokered deposits owned by institutions?

We have no data on the ownership of short versus long-term brokered deposits in failed banks. In this regard, however, it might be noted that the major brokers provide a secondary market for their brokered certificates so that long-term certificates of deposit provide essentially the same liquidity as short-term certificates from the point of view of their customers. Sale in the secondary market also avoids the early withdrawal penalties that otherwise would be applicable.

Senator **Gorton**. Ms. Kelsey, Mr. Falzon, Mr. Coloma, and Mr. Goldsmith are next on the agenda. We will take your testimony in that order.

As was the case with the two preceding witnesses, we have your full written statements, which will be included in the record as if read.

We will start with you, Ms. Kelsey.

STATEMENT OF SUSAN KELSEY, VICE PRESIDENT, STRATEGIC PLANNING, DEAN WITTER FINANCIAL SERVICES GROUP, SEARS, ROEBUCK & CO.

Ms. **Kelsey**. Mr. Chairman and members of the subcommittee, thank you for the invitation to appear before the subcommittee today. Your agenda is full this morning, so my remarks will be brief, and with your permission we will supplement them with additional written material for the record.

Senator **Gorton**. We will be happy to include it in the record.

Ms. **Kelsey**. Sears, Roebuck & Co. is concerned with the issue of brokered deposits both as a recipient of such deposits through its savings and loan association, Sears Savings Bank, and as a broker of such funds through its securities brokerage affiliate, Dean Witter Reynolds.

BENEFITS PROVIDED BY INSURED BROKER DEPOSITS

Today, I would like to focus my comments on the benefits that insured brokered deposits provide to depository institutions, to the economy, and to consumers. Until very recently, my background has been as a corporate planner for Sears Savings Bank, so I feel most qualified to discuss the issue from the perspective of a savings and loan executive.

I will describe Sears Savings Bank's successful experience with brokered deposits and demonstrate how brokered deposits, properly regulated, would lead to a strengthened depository institutions industry.

Individual depository institutions benefit from the use of brokered funds in a number of ways.

First, funds raised through brokers are generally less expensive than funds obtained through traditional branch networks which require a large investment in fixed assets and personnel overhead.

Second, brokered deposits can provide access to the longer term funds which are so necessary to the process of balancing assets and liabilities to avoid maturity mismatches. Such mismatches have been the principal cause of the recent losses incurred by S&L's.

Sears Savings Bank relies on both insured and uninsured brokered deposits in its funding strategy. As of the end of May, uninsured accounts represented some 27 percent of Sears Savings Bank's total deposit base. Insured brokered deposits represented about 17 percent of the total deposit base. These insured brokered funds, in particular, represent a new and expanded customer base, a significant source of new deposit growth, and they help the Savings Bank achieve important asset-liability restructuring goals.

Third, the insured deposit brokering mechanism provides institutions, particularly smaller ones and new entrants, access to money markets outside of their local geographic base, thereby enhancing competition.

Fourth, brokered funds permit well-managed institutions to meet market demands, which is particularly important in today's competitive marketplace. It is important to note that those institutions which have failed and have had a high percentage of brokered funds have failed not because of the way the funds were gathered, but because of the way the institutions were managed and how those funds were invested.

The economy as a whole also benefits from brokered funds in that they facilitate the Nation's flow of funds, moving money from capital-rich, investment-poor areas to capital-poor areas with high-growth potential. This movement tends to stabilize money costs nationwide. Additionally, more loans will be available for housing if thrifts are able to continue to compete with the money market funds for consumers' deposits.

Finally, and certainly not least, consumers benefit from the availability of insured, brokered deposits. Brokered deposits provide consumers with access to high-quality, fixed-income instruments having competitive market rates, convenience and liquidity, all without sacrificing safety. Today brokered deposits give the small depositor the same advantages formerly available only to depositors investing $100,000 or more.

In addition, such deposits give all consumers more investment options by not restricting them to a local market or to a particular investment vehicle. Through the use of a broker, consumers can seek out higher yields and greater safety for their investments.

All of these advantages readily fit within, and clearly do not abuse, our Federal Deposit Insurance System. Federal deposit insurance was intended to assure depositors that they could safely invest their money in the country's financial institutions. The fact that some depositors do this through a broker rather than directly at a branch of a local institution is in no way a misuse of deposit insurance.

Some banking regulators have stated that the continued availability of Federal deposit insurance on brokered deposits results in a disincentive for money brokers to conduct a comprehensive review of the financial soundness of the depository institutions for which they are brokering funds.

Dean Witter conducts a comprehensive and ongoing analysis of the financial soundness of the depositories for which it brokers deposits. The analysis Dean Witter performs on potential CD issuers is identical to that which it would perform if it were extending credit to the institution. We review both audited financial statements and reports filed periodically with bank regulators and, when necessary, we interview an institution's senior management.

SEARS SUPPORTS S. 791

We recognize, Mr. Chairman, that there are situations in which a depository institution's rapid growth which it chooses to fund through brokered deposits may, depending on the facts and circumstances, be a source of regulatory concern. Sears therefore heartily supports S. 791, introduced by Senators D'Amato and Mattingly, as a proposal which addresses the potential misuse of brokered funds without slamming the door on constructive uses of these funds.

To begin with, the bill limits an institution's ability to accept short-term, brokered deposits to 15 percent of its total deposits. We believe that provision alone would reduce most misuses of brokered deposits.

We also support S. 791, because it does nothing to hamper the long-term, brokered funds market which is vital to the asset-liability restructuring efforts of the thrift industry. Only by properly restructuring will thrifts regain their viability as an industry.

Mr. Chairman, you have asked the witnesses to comment on the future and integrity of the Federal Deposit Insurance System in light of the utilization of brokered funds by depository institutions. Sears believes S. 791 will actually help reduce potential drains on the insurance funds maintained by the FDIC and the FSLIC.

First, depository institutions will become stronger by being better able to meet their funding needs through brokered deposits.

Second, by limiting the amount of short-term brokered deposits, or so-called hot money, which are the funds most prone to be used by troubled depository institutions, S. 791 reduces the potential of losses to the deposit insurance funds.

However, passage of S. 791 must be accompanied by renewed efforts by the bank regulators to enforce regulations designed to make sure that insured institutions conduct their business in a safe and sound manner.

In short, Sears supports S. 791 and believes that if it is passed and enforced vigorously, it would go a long way to alleviate the possibility that mismanaged savings institutions could put a burden on the Federal Deposit Insurance System through the misuse of brokered funds.

We commend you, Mr. Chairman and members of this subcommittee, for conducting this important hearing on this important issue.

On behalf of Sears, Roebuck & Co., I particularly want to thank Senators D'Amato and Mattingly for their very positive and constructive contribution to resolving the concerns that surround the issue of the deposit insurance system and brokered funds.

Thank you for your attention, and I will be pleased to answer your questions.

[The complete prepared statement follows:]

STATEMENT OF SUSAN KELSEY
VICE PRESIDENT - STRATEGIC PLANNING
CONSUMER BANKING DIVISION
DEAN WITTER FINANCIAL SERVICES GROUP
SEARS, ROEBUCK AND CO.

MR. CHAIRMAN AND MEMBERS OF THE SUBCOMMITTEE,

THANK YOU FOR THE INVITATION TO APPEAR BEFORE THE SUBCOMMITTEE TODAY. YOUR AGENDA IS OBVIOUSLY FULL THIS MORNING, SO MY REMARKS WILL BE BRIEF AND WITH YOUR PERMISSION I WILL SUPPLEMENT THEM WITH ADDITIONAL WRITTEN MATERIAL FOR THE RECORD.

SEARS, ROEBUCK AND CO. IS CONCERNED WITH THE ISSUE OF BROKERED DEPOSITS AS BOTH A RECIPIENT OF BROKERED DEPOSITS THROUGH ITS SAVINGS AND LOAN ASSOCIATION - SEARS SAVINGS BANK - AND AS A BROKER OF SUCH DEPOSITS THROUGH ITS SECURITIES BROKERAGE AFFILIATE, DEAN WITTER REYNOLDS.

TODAY I WOULD LIKE TO FOCUS MY COMMENTS ON THE BENEFITS INSURED BROKERED DEPOSITS PROVIDE TO DEPOSITORY INSTITUTIONS, TO THE ECONOMY AND TO CONSUMERS. MY BACKGROUND HAS BEEN AS A CORPORATE PLANNER FOR SEARS SAVINGS BANK UNTIL VERY RECENTLY SO I FEEL MOST QUALIFIED TO DISCUSS THE PERSPECTIVE, OF A SAVINGS AND LOAN EXECUTIVE. I WILL DESCRIBE SEARS SAVINGS BANK'S SUCCESSFUL EXPERIENCE WITH BROKERED DEPOSITS AND DEMONSTRATE HOW BROKERED DEPOSITS - PROPERLY REGULATED - WOULD LEAD TO A STRENGTHENED DEPOSITORY INSTITUTION INDUSTRY.

INDIVIDUAL DEPOSITORY INSTITUTIONS BENEFIT FROM THE USE OF BROKERED FUNDS IN A NUMBER OF WAYS.

FUNDS RAISED THROUGH BROKERS ARE GENERALLY LESS EXPENSIVE THAN FUNDS OBTAINED THROUGH TRADITIONAL BRANCH NETWORKS BECAUSE THESE NETWORKS REQUIRE A LARGE INVESTMENT IN FIXED ASSETS AND PERSONNEL OVERHEAD. IN ADDITION, THEY PROVIDE ACCESS TO LONGER TERM FUNDS WHICH ARE SO NECESSARY TO THE PROCESS OF BALANCING ASSETS WITH LIABILITIES TO AVOID MATURITY MISMATCHES. SUCH MISMATCHES HAVE BEEN THE PRINCIPAL CAUSE OF THE RECENT LOSSES INCURRED BY S & L'S.

SEARS SAVINGS BANK RELIES ON BOTH INSURED AND UNINSURED BROKERED DEPOSITS TO MEET ITS ASSET AND LIABILITY MATCHING GOALS. AS OF THE END OF MAY, UNINSURED ACCOUNTS REPRESENT SOME 27% OF SEARS SAVINGS BANK'S TOTAL DEPOSIT BASE. INSURED BROKERED DEPOSITS ON THE OTHER HAND REPRESENT 16.8% OF SEARS SAVINGS BANK'S TOTAL DEPOSIT BASE. NOT ONLY DO THESE FUNDS REPRESENT A SIGNIFICANT PORTION OF SEARS SAVINGS BANK'S NEW DEPOSIT GROWTH BUT THEY HELP ACHIEVE IMPORTANT ASSET AND LIABILITY RESTRUCTURING GOALS.

THE INSURED DEPOSIT BROKERING MECHANISM ALSO PROVIDES INSTITUTIONS - PARTICULARLY SMALLER ONES - ACCESS TO MONEY MARKETS OUTSIDE OF THEIR LOCAL GEOGRAPHIC BASE.

IN ADDITION, BROKERED FUNDS PERMIT WELL MANAGED INSTITUTIONS TO MEET MARKET DEMANDS - PARTICULARLY IN TODAY'S COMPETITIVE MARKETPLACE. IT IS IMPORTANT TO NOTE THAT THOSE INSTITUTIONS WHICH HAVE FAILED, AND HAVE HAD A HIGH PERCENTAGE OF BROKERED FUNDS, HAVE FAILED NOT BECAUSE OF THE WAY THE FUNDS WERE GATHERED, BUT RATHER THE WAY THE INSTITUTIONS WERE MANAGED.

THE ECONOMY AS A WHOLE BENEFITS FROM BROKERED FUNDS IN THAT THEY FACILITATE THE FLOW OF FUNDS FROM CAPITAL RICH, INVESTMENT POOR AREAS TO CAPITAL POOR AREAS WITH HIGH GROWTH POTENTIAL. THIS TENDS TO STABILIZE MONEY COSTS NATIONWIDE. ADDITIONALLY, MORE LOANS FOR HOUSING WILL BE AVAILABLE IF THRIFTS ARE ABLE TO USE FUNDS FORMERLY HELD BY MONEY FUNDS.

FINALLY, CONSUMERS BENEFIT FROM THE AVAILABILITY OF INSURED BROKERED DEPOSITS. BROKERED DEPOSITS PROVIDE CONSUMERS WITH ACCESS TO HIGH QUALITY, FIXED INCOME INSTRUMENTS HAVING COMPETITIVE MARKET RATES, CONVENIENCE AND LIQUIDITY WITHOUT SACRIFICING SAFETY. TODAY, THE SMALL DEPOSITOR HAS THE SAME ADVANTAGES FORMERLY AVAILABLE ONLY TO DEPOSITORS INVESTING $100,000 OR MORE.

IN ADDITION, SUCH DEPOSITS GIVE ALL CONSUMERS MORE INVESTMENT OPTIONS BY NOT RESTRICTING THEM TO A LOCAL MARKET OR TO A PARTICULAR INVESTMENT VEHICLE. THROUGH THE USE OF A BROKER, CONSUMERS CAN SEEK OUT HIGHER YIELDS AND GREATER SAFETY FOR INVESTMENTS.

ALL OF THESE ADVANTAGES READILY FIT WITHIN, AND CLEARLY DO NOT ABUSE, OUR FEDERAL DEPOSIT INSURANCE SYSTEM. FEDERAL DEPOSIT INSURANCE WAS INTENDED TO ASSURE DEPOSITORS THAT THEY COULD SAFELY INVEST THEIR MONEY IN THE COUNTRY'S FINANCIAL INSTITUTIONS. THE FACT THAT SOME DEPOSITORS DO THIS THROUGH A BROKER RATHER THAN DIRECTLY AT A BRANCH OF A LOCAL FINANCIAL INSTITUTION IS IN NO WAY A MISUSE OF DEPOSIT INSURANCE.

SOME BANKING REGULATORS HAVE STATED THAT THE CONTINUED AVAILABILITY OF FEDERAL DEPOSIT INSURANCE ON BROKERED DEPOSITS RESULTS IN A DISINCENTIVE FOR MONEY BROKERS TO CONDUCT A COMPREHENSIVE REVIEW OF THE FINANCIAL SOUNDNESS OF THE DEPOSITORY INSTITUTIONS.

DEAN WITTER CONDUCTS A COMPREHENSIVE AND ONGOING ANALYSIS OF THE FINANCIAL SOUNDNESS OF THE DEPOSITORY INSTITUTIONS FOR WHICH IT BROKERS DEPOSITS. DEAN WITTER PERFORMS AN ANALYSIS ON POTENTIAL CD ISSUERS IDENTICAL TO THAT WHICH IT WOULD PERFORM IF IT WERE EXTENDING CREDIT TO THE INSTITUTION. WE REVIEW AUDITED FINANCIAL STATEMENTS AND REPORTS FILED PERIODICALLY WITH BANK REGULATORS AND, WHEN NECESSARY, WE INTERVIEW AN INSTITUTION'S SENIOR MANAGEMENT, INCLUDING THE CHIEF FINANCIAL OFFICER.

WE RECOGNIZE, MR. CHAIRMAN, THAT THERE ARE SITUATIONS IN WHICH A DEPOSITORY INSTITUTION'S RAPID GROWTH THROUGH THE USE OF BROKERED DEPOSITS MAY, DEPENDING ON THE FACTS AND CIRCUMSTANCES, BE A SOURCE OF REGULATORY CONCERN. SEARS THEREFORE HEARTILY SUPPORTS S. 791, INTRODUCED BY SENATOR D'AMATO AND SENATOR MATTINGLY, AS A PROPOSAL WHICH ADDRESSES THE CONCERNS OF REGULATORS ON THE POTENTIAL MISUSE OF BROKERED FUNDS WITHOUT SLAMMING THE DOOR SHUT ON CONSTRUCTIVE USES OF SUCH FUNDS.

TO BEGIN WITH, THE BILL LIMITS AN INSTITUTION'S ABILITY TO ACCEPT SHORT-TERM BROKERED DEPOSITS TO 15% OF ITS TOTAL DEPOSITS. WE BELIEVE THAT PROVISION ALONE WOULD REDUCE MOST MISUSES OF BROKERED DEPOSITS BY INSURED DEPOSITORY INSTITUTIONS. WE ALSO SUPPORT S. 791 BECAUSE IT DOES NOTHING TO HAMPER THE LONG TERM BROKERED FUNDS MARKET WHICH IS SO VITAL TO THE ASSET AND LIABILITY RESTRUCTURING EFFORTS OF THE THRIFT INDUSTRY TODAY. ONLY BY PROPER RESTRUCTURING EFFORTS WILL THRIFTS REGAIN VIABILITY AS AN INDUSTRY.

MR. CHAIRMAN, YOU HAVE ASKED THE WITNESSES TO COMMENT ON THE FUTURE AND INTEGRITY OF THE FEDERAL DEPOSIT INSURANCE SYSTEM IN LIGHT OF THE UTILIZATION OF BROKERED FUNDS BY DEPOSITORY INSTITUTIONS. SEARS BELIEVES S. 791 WILL ACTUALLY HELP REDUCE POTENTIAL DRAINS ON INSURANCE FUNDS MAINTAINED BY THE FDIC AND FSLIC. FIRST, DEPOSITORY INSTITUTIONS WILL BECOME STRONGER BY BEING BETTER ABLE TO MEET FUNDING NEEDS THROUGH BROKERED FUNDS. SECOND, BY LIMITING THE AMOUNT OF SHORT-TERM BROKERED FUNDS OR SO-CALLED "HOT-MONEY," WHICH ARE MOST PRONE TO BE USED BY TROUBLED DEPOSITORY INSTITUTIONS, WE BELIEVE S. 791 REDUCES POTENTIAL LOSSES TO THE DEPOSIT INSURANCE FUNDS.

PASSAGE OF S. 791 SHOULD BE ACCOMPANIED BY RENEWED EFFORTS BY THE BANK REGULATORS TO ENFORCE REGULATIONS DESIGNED TO MAKE SURE THAT INSURED INSTITUTIONS CONDUCT THEIR BUSINESS IN A SAFE AND SOUND MANNER. IN SHORT, SEARS SUPPORTS S. 791 AND BELIEVES THAT IF IT IS PASSED AND ENFORCED VIGOROUSLY, IT WOULD GO A LONG WAY TO ALLEVIATE THE POSSIBILITY THAT MISMANAGED SAVINGS INSTITUTIONS COULD PUT A BURDEN ON THE FEDERAL DEPOSIT INSURANCE SYSTEM THROUGH THE MISUSE OF BROKERED DEPOSITS.

I COMMEND YOU MR. CHAIRMAN AND MEMBERS OF THIS SUBCOMMITTEE FOR CONDUCTING THIS IMPORTANT HEARING ON THE ISSUE OF BROKERED DEPOSITS.

ON BEHALF OF SEARS, ROEBUCK AND CO., I PARTICULARLY WANT TO THANK SENATOR D'AMATO AND SENATOR MATTINGLY FOR THEIR VERY POSITIVE AND CONSTRUCTIVE CONTRIBUTION TO RESOLVING THE CONCERNS THAT SURROUND THE ISSUE OF THE DEPOSIT INSURANCE SYSTEM WITH REGARDS TO THE USES OF BROKERED FUNDS.

THANK YOU FOR YOUR ATTENTION AND I WILL BE PLEASED TO DO MY BEST TO ANSWER YOUR QUESTIONS.

WRITTEN SUBMISSION

BY

SUSAN KELSEY

VICE PRESIDENT - STRATEGIC PLANNING

Consumer Banking Division

DEAN WITTER FINANCIAL SERVICES GROUP

SEARS, ROEBUCK AND CO.

Before the

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS

AND CONSUMER AFFAIRS

of the

COMMITTEE ON

BANKING HOUSING AND URBAN AFFAIRS

U.S. Senate

On the issue of

Brokered Deposits

JUNE, 1985

Underlying market forces as well as explicit regulatory and legislative actions are profoundly changing the financial services industry in this country.

Sears recognizes that, in a time of dynamic change, concerns arise regarding the safety of the federal deposit insurance system due to the increased likelihood of financial institution failures. Some failures will occur because institutions are not able to deal with the changed economic environment in which they must operate. The high rate of failures in the savings and loan industry in recent years is a prime example. Prudent banks with loans to failing farmers and with loans in areas hit hard by adverse economic factors are other examples. Some of the failures occur because management simply does not have the vision to cope with a changing and increasingly competitive environment. Finally, failures resulting from mismanagement, fraud, and abuse, will likely continue and may increase.

Recently, the regulators have cited another cause of failure -- the use of insured brokered funds. Sears recognizes that the potential misuse of brokered funds is a cause for concern on the part of the regulators, but we strongly disagree with the regulators' assertions that there is a cause and effect relationship between their use and institution failure. In seeking to prevent possible abuses to the deposit insurance system -- specifically with regard to brokered deposits -- care must be taken to ensure that corrective regulatory or legislative solutions are carefully tailored to deal only with the abuses. Solutions must avoid stifling healthy, well-managed depository institutions or the benefits of innovative changes in the marketing of financial services.

With this basic perspective as background, I will supplement -- by this written submission -- the oral comments I made before the Subcommittee. Sears appreciates this opportunity.

This additional material will provide the Subcommittee with information regarding the status of the use of brokered deposits, the problems associated with alternative legislative and regulatory proposals for dealing with brokered funds, and the degree to which these alternative proposals are consistent with federal policy regarding deposit insurance.

STATUS OF THE USE OF BROKERED DEPOSITS

First, it is important to define what is meant by the term "brokered funds." We believe that an extensive and accurate definition and analysis of the brokered funds market has been conducted by Merrill Lynch. Merrill Lynch has identified three basic markets: institutional uninsured brokered funds, institutional insured brokered funds and individual insured brokered funds.

The uninsured brokered funds market has existed since the early 1960's. Investors are institutions such as money market funds, corporations, bank trust departments and insurance companies. The certificates of deposit are issued by the larger banks and a few of the largest thrifts. According to Merrill Lynch's analysis, approximately $46 billion were outstanding at year-end 1984.

The second market is the institutional insured market. Merrill Lynch estimates that the market comprised about $10 billion outstanding at year-end 1984 and tends to involve the break-up of large deposits in banks and S & Ls into insurable amounts. This market's growth accelerated after the failure of Penn Square.

The individual insured market is the newest of the three markets, having arisen as a result of decisions by the Depository Institutions Deregulation Committee which started the process of deregulating rates on CDs of less than $100,000 and authorized their issuance in negotiable form. This market, Merrill Lynch estimates, was about $32 billion at year-end 1984 with individual accounts averaging $14,000 in amount.

Despite the clear differences in these markets, the tendency of the regulators has been to lump them together statistically when making statements about the size of the brokered funds market and hence the potential magnitude of the problem they perceive. This is unfortunate, and also potentially misleading, since the institutional uninsured brokered funds market, which is the largest component, does not pose a threat to the insurance fund and therefore, should not be the focus of either the Subcommittee or the regulators. We think the facts demonstrate that the institutional insured brokered funds market, by far the smallest of the three markets, is the most prone to abuse. (We would refer the Subcommittee to Merrill Lynch's written submission to the Subcommittee for additional details and descriptions of these markets.)

In terms of the proposed regulatory solutions we have seen, the two insured markets tend to be treated together as a target for being stripped of insurance eligibility. This is despite the important benefits insured brokered deposits -- in particular in the individual market -- are currently providing. These benefits include benefits to depository institutions, to consumers and to the national economy, as described below.

Such brokered funds are providing depository institutions with a ready and flexible source of liquidity.

The insured deposit brokering mechanism allows all institutions, but especially small ones and new entrants, access to money markets outside of their local geographic base, thereby enhancing competition.

Funds raised through brokers are generally less expensive than funds obtained through traditional branch networks because these networks require a large investment in fixed assets and personnel overhead.

Brokered funds provide institutions greater access to longer term funds which are essential to the process of balancing assets with liabilities to avoid maturity mismatches. It is important to note that in recent years such mismatches have been the principal cause of the losses incurred by savings and loan associations.

In addition, brokered funds are permitting well managed institutions to meet market demands, which is particularly important in today's competitive marketplace. Brokered deposits, properly regulated, lead to a strengthened depository institutions industry.

Consumers also benefit from the availability of insured brokered deposits. These deposits provide consumers with access to high quality, fixed income instruments having competitive market rates, convenience and liquidity, all without sacrificing safety.

In addition, such deposits provide all consumers with more investment options by not restricting them to a local market or to a particular investment vehicle. Through the use of a broker, consumers are seeking out higher yields and greater safety for investments than might be available locally.

The national economy is better served through the availability of brokered deposits in that more loans for housing are available when thrifts are able to compete with the money market mutual funds for consumers' deposits.

In addition, deposit brokerage has performed the important function of moving funds from capital surplus areas to capital deficient areas with high growth potential. This tends to stabilize money costs nationwide.

In summary, brokered deposits are currently providing the nation's depository institutions and consumers with a variety of sound financial options. Deposit brokerage enhances a depositor's options as to where and how to deposit funds, they enhance depository institutions' options, and they increase the efficiency of the financial intermediation system. All of these advantages readily fit within, and clearly do not abuse, our federal deposit insurance system.

Federal deposit insurance was intended to assure depositors that they could safely invest their money in the country's financial institutions. The fact that some depositors prefer to go to a money broker to place deposits rather than go directly to a branch of a local financial institution is in no way a misuse of the deposit insurance system.

The major criticism of money brokers centers around the charge that market discipline has eroded under the current money broker system.

In the case of an SEC registered broker dealer such as Dean Witter, this simply is not accurate. Dean Witter conducts a comprehensive analysis of the financial soundness of the depository institutions for which it brokers deposits. The analysis on potential certificate of deposit issuers is identical to that which Dean Witter would perform if it were extending credit to the institution. This credit analysis includes a thorough evaluation of information contained in monthly call reports, an appraisal of management expertise, capitalization requirements, quality and configuration of portfolio assets and so forth. While the use of a credit analysis can not give an absolute assurance of financial soundness, it does highlight problem institutions for which Dean Witter will not broker deposits.

Dean Witter conducts a credit analysis primarily for two reasons. First, Dean Witter is concerned about its ongoing relationship with the client purchasing the certificate of deposit. In the event of a depository institution's failure in which the client's brokered deposits are affected, Dean Witter believes it would lose the confidence -- and the future business -- of that client. Therefore, the credit analysis is of utmost importance in the conduct of Dean Witter brokerage business.

The second reason for implementing a rigorous credit analysis is Dean Witter's commitment to making a secondary market in the deposits brokered. For example, if a five year certificate of deposit ("CD") is sold to an individual who, within two years, wishes to retrieve those savings, Dean Witter would repurchase the CD and resell it to a different individual wishing to purchase a three year CD with that particular rate of interest.

At any one time, some repurchased CDs might not be immediately resold and therefore would be held in inventory. Since brokers holding such CDs in inventory are only covered up to $100,000 in deposit insurance, a strong incentive exists to broker only the deposits for institutions which are financially stable. This assures the broker that losses will not be suffered on the CDs held in inventory.

Because of the two previously discussed reasons, Dean Witter believes that market discipline as to SEC registered broker-dealers is currently functioning.

ALTERNATIVE LEGISLATIVE AND REGULATORY PROPOSALS

Sears recognizes that there are situations in which a depository institution's rapid growth, which it chooses to fund through the use of brokered deposits may, depending on the facts and circumstances, be a source of regulatory concern. Sears therefore supports legislative proposals which address the concerns of regulators on the potential misuse of brokered funds by unsound institutions without eliminating constructive uses of such funds.

Several legislative proposals -- S. 759 and S. 760 -- have been introduced in the Senate which, while not directly limiting brokered deposits, would in effect give each agency broad new powers to promulgate rules to limit or eliminate brokered deposits.

As discussed earlier, Sears opposes measures which have the effect of eliminating or significantly curtailing insured deposit brokerage, thereby eliminating the benefits deposit brokerage provides to depository institutions, the national economy and the consumer.

Recently, the FHLBB issued a proposed revision to its record-keeping requirements which, while offering clarification of existing regulations, would require broker-dealers to provide an issuing institution with names and addresses of customers for which it brokers deposits. The regulation is duplicative in nature and would require depository institutions and deposit brokers to restructure current administrative procedures with regards to brokering deposits which are highly effective and economical from the view point of both the broker and the depository institution. A result of this regulation could be to eliminate insured brokered deposits. The likely practical effect of the regulation would be to increase the expense associated with brokering deposits while overlooking the potential problems associated with the misuse of brokered funds by weak institutions. (We refer the Subcommittee to the Dean Witter and Sears Savings Bank comment letters to the FHLBB on the proposed regulation which are attached to this written submission).

Sears endorses the approach taken by Senator D'Amato and Senator Mattingly in S. 791. The proposal addresses the concerns of regulators on the potential misuse of brokered funds while providing for constructive uses of such funds.

To begin with, the bill limits an institution's ability to accept short-term brokered deposits to 15% of its total deposits. We believe that provision alone would reduce most misuses of brokered deposits. S. 791 does nothing to hamper the long-term brokered funds market which is so vital to the asset and liability restructuring efforts of the thrift industry. Only by proper restructuring efforts will thrifts regain viability as an industry.

FEDERAL POLICY REGARDING DEPOSIT INSURANCE

S. 791 is consistent with federal policy regarding deposit insurance. In fact, Sears believes S. 791 will actually help reduce potential drains on insurance funds maintained by the FDIC and FSLIC. First, brokered deposits could be used by depository institutions as a vehicle to become stronger by being better able to meet funding needs. Second, by limiting the amount of short-term brokered funds or so-called "hot money," which are most prone to be used by troubled depository institutions, S. 791 reduces the potential of losses to the deposit insurance funds.

Passage of S. 791 should be accompanied by renewed efforts by bank regulators to enforce regulations designed to make sure that insured institutions conduct their business in a safe and sound manner.

In summary, Sears believes that S. 791, if it is passed and rigorously enforced, would go a long way to alleviate the possibility that mismanaged depository institutions could put a burden on the federal deposit insurance system through the misuse of brokered deposits. Any other approaches, particularly those aimed at eliminating or severely curtailing deposit insurance for brokered funds, will harm rather than help depository institutions, the economy, and consumers.

Sears appreciates this opportunity to present its views to this Subcommittee.

SEARS SAVINGS BANK

SSB

701 North Brand Boulevard
Glendale, California 91203-1213
Telephone (818) 956-1600

June 27, 1985

Director, Information Services Section
Office of the Secretariat
Federal Home Loan Bank Board
1700 G Street N.W.
Washington, D.C. 20552

RE: Federal Register, Volume 50, No. 88, May 7, 1985
FHLBB Proposed Rule on Settlement Of Insurance

Dear Sirs:

In the above referenced issue of the Federal Register, the Federal Home Loan Bank Board ("FHLBB") has proposed rules (the "Proposed Rules") which would require extensive and far-reaching changes in recordkeeping requirements applicable to insured institutions in connection with insurance of accounts by the Federal Savings and Loan Insurance Corporation (the "FSLIC").

Set forth below, please find the comments of Sears Savings Bank, a California-chartered savings bank, with respect to the Proposed Rules.

The provision of the Proposed Rules which would adversely affect Sears Savings Bank is the proposed change in recordkeeping requirements found at Section 564.2(b)(2) of the Proposed Rules. Of course, under present FHLBB Rules, if the existence of a relationship such as trustee, agent, custodian or executor is disclosed on the records of the insured institution, it is sufficient for FSLIC insurance if the records of the account holder, maintained in good faith and in the regular course of business, describe the details of the relationship and the interests of other parties. [12 C.F.R. 564.2(b)(1) and (2)].

However, contrary to the existing Rules, the Proposed Rules, at Section 564.2(b)(2), provide, with exceptions only for an irrevocable express trust, an employee-benefit plan, a public-unit account, an account held by a loan servicer, or a court registry account, that:

> "(2) In the case of an account established pursuant to any other type of relationship [i.e., other than the exceptions listed above] the identities and interests of persons or entities having interests in the account which provide the basis for additional insurance must be disclosed in the records of the insured institution."

Thus, for example, accounts held in the name of a securities firm or other nominee owner would be uninsured unless the securities firm or nominee owner delivered to Sears Savings Bank (and updated as necessary to reflect secondary market activity) a list of the beneficial owners of the accounts (as well as their respective interests in the accounts.) Similarly, the identity of the beneficial owner and principal of fiduciary or agency accounts would have to be disclosed on the records of the insured institution.

In addition, the term "records of the insured institution" is defined at proposed Section 564.2(e) as not including any records held or maintained by any person other than the insured institution, with respect to an account held by such person or with respect to which such person has any interest in any capacity. This Proposed Rule would prevent an insured institution from designating an interested third party, such as a securities firm, to maintain its account records pertaining to CDs.

Sears Savings Bank believes that, as a matter of public policy, Proposed Rule 564.2(b)(2) is not required for the protection of FSLIC with respect to future accounts issued by insured institutions. Even more, we believe that the Board would be acting in an arbitrary and capricious manner if it proposes to make Rule 564.2(b)(2) applicable to accounts previously issued under different insurance of accounts rules. The Board has requested public comment on the question of whether grandfathering should be permitted for existing time deposits, for the "convenience" of persons who have made long-term investments in insured accounts under the existing rules [50 Fed. Reg. 88, p19192]. Sears Savings Bank believes that such grandfathering of existing accounts must be provided for, so that its customers--who legitimately became entitled to Federal deposit insurance pursuant to purchase terms and recordkeeping rules previously in effect--will remain entitled to Federal deposit insurance.

In order to show the inequitableness which would occur, if the Board adopts Proposed Rule 564.2(b)(2), and especially if it retroactively requires insured institutions to maintain the records described in Proposed Rule 564.2(b)(2) with respect to previously issued accounts, it is first necessary to describe the procedure for offerings of Sears Savings Bank Certificates of Deposits ("CDs").

In such CD offerings, a nationwide securities firm acts as the manager of the offering and forms a syndicate to offer the CDs. Federal insurance protection of the CD is maintained by reason of an audit trail from Sears Savings Bank to a nominee owner to the securities firms and last to the customer. The system is a pure book entry system and the only physical security delivered is a single master certificate.

The beneficial owners of the CDs are determined by reference first to the records of Sears Savings Bank, which show participating broker-dealers, and that they are holders of the CDs as agents of the beneficial owners, and subsequently by reference to the records of the individual broker-dealers identifying the specific beneficial owners. Since the securities firms maintain an active secondary market in the CDs which have been issued by Sears Savings Bank, the beneficial ownership of such CDs will vary each day, and it is only the securities firms which have accurate records concerning who are the present beneficial owners of Sears Savings Bank CDs.

Thus, contrary to existing regulations in Part 564, which do not require an insured institution to maintain records with respect to the identities and interests of its CD owners, Proposed Rule 564.2(b)(2) would require, entirely retroactively, that Sears Savings Bank ask underwriters if they will provide, (totally without any contractual obligation so to do, and on a daily basis), an update of the beneficial owners of the Sears Savings Bank CDs.

In explaining its purposes for proposing Rule 564.2(b)(2), the Board states:

> "For relationships other than irrevocable express trusts, employee benefit plans, loan servicing accounts, and accounts held by court registries or by public units, the proposed rule would require disclosure of the identities and

interests of persons having beneficial ownership interests in the account records of the institution. The proposal provides that the complete details of any relationship (other than those described above) would be required to be disclosed on the records of the insured institution. This provision would, in the Board's view, provide the FSLIC with sufficient information to:

(1) Prevent post-default invention of relationships designed to fraudulently increase insurance coverage,

(2) determine the insurance on such accounts quickly and efficiently, thus lessening the delay in payment on those and other accounts in an insurance settlement, and

(3) make well-informed decisions as to potential costs of various alternatives in considering what course of action to take with respect to an insolvent institution. [50 Fed. Reg., No. 88 p. 19189]

A brief analysis will show that each of the points relied upon by the Board is unpersuasive. First, with respect to the Board's Paragraph 1, we note that the records pertaining to beneficial ownership of Sears Savings Bank's CDs are now in the possession of major securities firms, which maintain such records in the ordinary course of their business, and which certainly have no reason or incentive to engage in fraud or post-default invention of relationship.

If the Board is truly concerned about fraud and post-default invention of relationship, it could merely promulgate its Proposed Rule 564.2(b)(2) in the alternative; i.e., the Board could require maintenance of records at the insured institution according to the Proposed Rule as currently written or maintenance of such records in the normal course of business at a different company, (one which is responsible according to criteria developed by the Board), which company has agreed to furnish such records to FSLIC within a designated number of days after request by FSLIC upon failure or distress of an insured institution.

As to the Board's Paragraph 2, it is clear that records maintained by other responsible companies could be made quickly available to the FSLIC, pursuant to a prior agreement therefor from such other company or companies. Again, the alternative formulation of Proposed Rule 564.2(b)(2) suggested above would equally meet the Board's stated concern.

Finally, with respect to the Board's Paragraph 3, again, it is evident that ownership records maintained by other responsible companies in the normal course of business would be accurate, and could be made quickly available to FSLIC pursuant to a prior agreement therefor. As in each instance above, the alternative formulation of Proposed Rule 564.2(b)(2) would equally fulfill the Board's stated concern. Thus, if an alternative formulation of Proposed Rule 564.2(b)(2) were promulgated, it would still be up to the insured institution to maintain the records described in Proposed Rule 564.2(b)(2) unless the insured institution could demonstrate that a responsible company maintained such records in the ordinary course of its business, and that such company was willing to agree to furnish those records to FSLIC promptly upon request therefor.

In illustration, if the subject records were now available to Sears Savings Bank at all, it would only be because the records had been furnished by securities firms which maintain a secondary market in Sears Savings Bank CDs. Therefore, under any circumstances, any records which Sears Savings Bank will have concerning beneficial ownership of its CDs will be those records furnished to it by one or more securities firms. This illustrates the reasonableness of alternative formulation of Proposed Rule 564.2(b)(2), whereby the insured institution would maintain the specified records or another responsible company would maintain such records pursuant to a prior agreement with the FSLIC.

In conclusion, Sears Savings Bank wishes to reaffirm that basic standards of fairness and due process require that existing accounts must be grandfathered. As to future accounts, Sears Savings Bank has suggested an alternative formulation of Proposed Rule 564.2(b) which satisfies all of the Board's stated concerns. If the Board does not consider such an alternative formulation of Proposed Rule 564.2(b)(2), it appears that its Proposed Rule 564.2(b)(2) was conceived in an attempt to hinder the brokered CD market. In these circumstances, the Board's self-serving statement that the Proposed Rules "would not cover those issues addressed in the Board's rule on deposits placed by or through deposit brokers..." is disingenuous at best.

Very truly yours,

Richard C. Fugate

Richard C. Fugate
Vice President and
Senior Counsel

RCF:dw

DEAN WITTER REYNOLDS INC.
#5 World Trade Center, New York, NY 10048   Telephone (212) 524-2222

June 28, 1985

Director, Information Services Section
Office of the Secretariat
Federal Home Loan Bank Board
1700 G. Street, N.W.
Washington, DC 20552

Re: 12CFR Part 564
(85-286a) Settlement of Insurance-Proposed Rule

Gentlemen:

Dean Witter Reynolds Inc. ("DWR") is pleased to respond to the Federal Home Loan Bank Board's (the "Board") request for comments published in the Federal Register on May 7, 1985 (50 Fed. Reg. 19185) concerning proposed revisions to its regulations pertaining to insurance accounts. This response will deal solely with those sections of the proposed regulations which propose revisions to the Board's recordkeeping requirements for agency accounts.

Introduction:

DWR endorses the Board's desire to clarify the operation of these regulations and fulfill its statutory mandate to settle insurance claims speedily while protecting the assets of the Federal Savings and Loan Insurance Corporation ("FSLIC") from fraud and abuse. DWR believes the proposed regulations are unnecessary and will not accomplish those goals.

The proposed regulations would require disclosure in the account records of the institution of the identities (and interests) of the beneficial owners of a deposit account for relationships other than irrevocable trusts, employee benefit plans, loan servicing accounts, and accounts held by court registries or by public units. Current regulations allow the identities of the beneficial owners of deposit accounts to be determined from the records of a nominee or agent, without regard to the nature of the relationship, provided that account records of the institution disclose the existence of such relationship.

The proposed regulations would eliminate the current exemption from the recordkeeping requirements for negotiable certificates of deposit ("CDs"), which are usually issued in the names of nominee agents. This would significantly impair the transferability of deposit accounts held through nominees or agents and thereby adversly affect a depositor's ability to sell his CD in the secondary market.

The proposed regulations would also require maintenance of duplicate records of beneficial ownership and thereby, impose substantial new operational burdens and costs on insured institutions.

DWR recommends that the Board not adopt its proposed revisions as they relate to recordkeeping requirements, for the following reasons:

1. Books and records required to be maintained by registered broker-dealers are adequate to meet the needs of the FSLIC for prompt disclosure of the details of agency or nominee relationships in order to determine insurance coverage.
2. The proposed regulations arbitrarily discriminate between the treatment of beneficial owners of accounts held by trustees or other fiduciaries and beneficial owners of accounts held by other agents or nominees.
3. The proposed regulations will impose additional costly and burdensome requirements on insured institutions.
4. The proposed regulations discriminate against brokered deposits.
5. The Board's stated goals set out in the proposed regulations could be achieved through less burdensome alternatives.

Discussion:

1. BOOKS AND RECORDS REQUIRED TO BE MAINTAINED BY REGISTERED BROKER-DEALERS ARE ADEQUATE TO MEET THE NEEDS OF THE FSLIC FOR PROMPT DISCLOSURE OF THE DETAILS OF AGENCY OR NOMINEE RELATIONSHIPS IN ORDER TO DETERMINE INSURANCE COVERAGE.

The books and records of registered broker-dealers are required to be kept in the ordinary course of business and can be used to validate claims for additional insurance coverage. The Securities and Exchange Commission ("SEC") has promulgated extensive requirements for all registered broker-dealers which carry cash or securities for public customers. The NASD and the Securities Exchanges perform routine examinations to insure compliance with those recordkeeping requirements. These records are required to include in respect of each customer account the name and address of the beneficial owner of such account. (17CFR 240.17a-3(a)(9))

Broker-dealer records are made and maintained in good faith in the ordinary course of business as required by law. Client relationships are not easily fabricated and various features of such relationships, including supervision by designated securities self-regulatory organizations, provide safeguards as to their genuineness and should work to prevent post-default invention of relationships designed to fraudulently increase insurance coverage. These recordkeeping systems are required to be efficient enough to process shareholder proxy soliciting materials within relatively short time frames mandated by the SEC and the NYSE. Thus, these systems are sufficiently detailed and accurate to achieve the FSLIC's stated goals of prompt settlement of insurance.

2. THE PROPOSED REGULATIONS ARBITRARILY DISCRIMINATE BETWEEN THE TREATMENT OF BENEFICIAL OWNERS OF ACCOUNTS HELD BY TRUSTEES OR OTHER FIDUCIARIES AND BENEFICIAL OWNERS OF ACCOUNTS HELD BY OTHER AGENTS OR NOMINEES.

The proposed regulations would establish certain exemptions from the requirement that the books and records of an insured institution disclose the beneficial owners of accounts. These exemptions, in section 564.2(b)(1), would apply to certain account relationships such as irrevocable trusts and employee benefit plans. The Board's rationale for limiting these exemptions to such relationships is that these types of relationships "are not as easily fabricated" as other types, chiefly agency and nominee relationships.

The Board's view is that these exempted account relationships include various features that provide safeguards as to their genuineness that are lacking in other relationships. This proposition is unsupported by any factual analysis. Further, we think it is inaccurate and would result in arbitrary differences in insurance benefits for similarly situated beneficial owners of deposit accounts.

Since the number and identities of the beneficial owners of employee benefit plan and irrevocable trust interests would not be required to be disclosed on an insured institution's records, we fail to see why they are not subject to the same potential for fabrication as beneficial ownership interests through agents or nominees. We submit that the Board will face as complicated and time consuming a task in settling many large denomination and complex fiduciary accounts, as it would have in settling large denomination and complex agent and nominee accounts.

It is unclear why the Board believes that recording on an insured institution's books the identities of beneficial owners will promote quick and efficient settlement of insurance in the case of agents or nominees but that such disclosure is unnecessary in the case of an employee benefit plan or irrevocable trust. The difficulty of the FSLIC's task of identifying the beneficial owners and determining their entitlement to insurance is dependent upon the aggregate number of depositors and the number of beneficiaries rather than the character of the agency relationships.

3. THE RULES AS CURRENTLY DRAFTED IMPOSE COSTLY AND BURDENSOME REQUIREMENTS ON INSURED INSTITUTIONS.

Under the current regulations the cost of maintaining books and records of beneficial ownership with respect to agent and nominee accounts is born directly by the agents and nominees and not by the insured institutions. The proposed revisions would require an insured institution to set up new systems to maintain and categorize large quantities of additional records. Because of the increased data processing burden associated with the number of potential beneficial owners of accounts held by nominees or agents and the large number of changes in beneficial ownership of such accounts, it is possible that these records could become inaccurate in the absence of the allocation of substantial resources to their maintenance.

The Board suggested that the records of an insured institution at the time of liquidation may not be complete or accurate (proposed regulation 564.2(f)). It is highly likely that those insured institutions which become troubled financial institutions will not continue to devote adequate personnel or the financial resources to maintain the additional records required by the proposed regulations. Thus, the Board is proposing that insured institutions maintain extensive and complex records of beneficial owners of deposit accounts necessary to establish insurance benefits of depositors when the institution may be unable to do so. The Board should not require that reliance be placed soley on an insured institution's books and records during a period when it is least able to devote significant attention to such record keeping requirements.

The proposed regulations would require insured institutions to upgrade account recordkeeping systems purchase data processing equipment, hire additional personnel and allocate additional space for record retention.

We submit that the burdens placed on insured institutions through these proposed regulations are costly and burdensome while at the same time do not adequately meet the aim of the Board to effect quick and efficient settlement of insurance.

4. THE PROPOSED REGULATIONS DISCRIMINATE AGAINST BROKERED DEPOSITS.

In the absence of a rational distinction between accounts for employee benefit plans or irrevocable trusts and agent or nominee accounts, it appears that one of the principal effects of the proposed revision to the recordkeeping rules will be to make such recordkeeping for agent or nominee accounts so burdensome as to eliminate or curtail brokered deposits.

As Judge Gesell noted in his opinion set out in FAIC Securities v. United States, Civ. Act No. 84-0959(DCDC June 20, 1984) aff'd Order No. 84-5408 (DC Cir January 30, 1985):

> "It is clear, therefore, that the (deposit insurance) statutes were intended to grant to each depositor federal deposit insurance up to the statutory ceiling regardless of the means by which that depositor placed his funds in an insured institution. The statutes, quite simply do not take into account the manner in which deposit of the funds is arranged, they focus instead on who owns the funds" ID at 9.

In FAIC Securities the court decided, in part, that the Board and the Federal Deposit Insurance Corporation

> "violated the central features of the deposit insurance statutes by depriving individual depositors of the full measure of insurance protection mandated by the statute if they place their deposits through deposit brokers..."

Although the proposed recordkeeping regulations do not directly restrict brokered deposits, by arbitrarily setting apart a class of depositors based on the manner in which the deposits are arranged, the effect is similar.

Furthermore, as the Board is aware, Congressional Committees are presently reviewing legislation regarding brokered deposits. It is clearly inconsistent for the Board to seek by rulemaking to eliminate brokered deposits while simultaneously seeking legislation which would regulate the circumstances under which deposits are obtained.

Finally, A bill (S. 2851) that passed the Senate last year would have prohibited the Board from issuing any regulations: "which would have the effect of causing the deposit insurance available to a person for deposits or accounts by or through a deposit broker to differ from deposit insurance available to such person for deposits or accounts not placed by or through a deposit broker." Substantially similar legislation was reintroduced in the current session of Congress in two bills, S.716 (Mattingly and S.791 (D'Amato and Mattingly).

5. THE BOARD'S STATED GOALS SET OUT IN THE PROPOSED REGULATIONS COULD BE ACHIEVED THROUGH LESS BURDENSOME ALTERNATIVES.

We believe that no change is needed with respect to records concerning the beneficial owners of accounts established through regulated broker-dealers. If the Board feels compelled to adopt revisions, an alternative to the proposed regulations would be to require that agents, nominees, trustees, etc. submit data on a periodic basis to a third party recordkeeping depository to which FSLIC would have access. This would give FSLIC a sophisticated data processing base to speed up insurance settlements and avoid reliance on an insolvent institution for primary record maintenance.

Effective Date:

If the Board determines to adopt the proposed regulations in their present form or adopt the alternative suggested above, considerable time will be needed to develop programs capable of transmitting such information to insured institutions or to a third-party. Based on our review of current data processing systems we believe that it could take as long as one year to develop the necessary software and delivery systems to implement either the proposed rule or the alternatives proposed above.

The Board should grandfarher all existing time deposits. This should be done not only for the "convenience of persons who have made long term investments in insured accounts", but also because individuals who purchased negotiable certificates of deposit have done so with the explicit understanding that such certificates would be transferable through secondary market trading. To not grandfather existing deposit accounts would disadvantage beneficial owners who established time deposits prior to the adoption of the proposed revisions in the good faith belief that these accounts were and would continue to be insured deposit accounts in accordance with the existing regulations governing record keeping and insurance coverage.

Conclusion:

We believe that the Board's stated purposes -- to settle insurance claims quickly while protecting the FSLIC funds from fraud and abuse -- will not be accomplished by these proposed regulations. They will create costly and duplicative record keeping burdens for insured institutions, many of which are ill equiped to handle such burdens. The FSLIC will ultimately have to refer to the records of agents and nominees in any case where there has been improper maintenance or loss of records by an insured institution.

The Board can attain its stated goals by other means and without the costly and burdensome recordkeeping requirements that would accompany implementation of the proposed revisions to the Board's current regulations.

Very truly yours,

Gordon E. Swartz

Gordon E. Swartz
First Vice President

Senator Gorton. Thank you, Ms. Kelsey.

Mr. Falzon.

STATEMENT OF EMANUEL FALZON, PRESIDENT, MERRILL LYNCH MONEY MARKETS, INC.

Mr. Falzon. Thank you, Mr. Chairman, and good morning. My name is Manny Falzon, and I am the president of Merrill Lynch Money Markets Inc., which is the Nation's largest dealer in commercial paper, bankers' acceptances, and certificates of deposit.

I want to thank you, Mr. Chairman and members of the subcommittee, for holding this hearing on brokered deposits at what is certainly a very busy time for the Committee on Banking and the Senate.

I have submitted a full copy of my testimony which I request be made part of the hearing record.

Senator Gorton. Without objection, it will be so included.

Mr. Falzon. Thank you.

MERRILL LYNCH SHARES CONCERN OF ABUSES

Before proceeding, Merrill Lynch shares the FDIC's concern about the Federal Deposit Insurance System and abuses of brokered deposits. However, we reject as inaccurate and totally misleading the statements made by the FDIC stating that Merrill Lynch has placed large amounts of fully insured deposits in troubled institutions. While we have not and cannot respond to charges relating to the bank regulators' CAMEL ratings since these are not publicly available, our credit evaluation system allows us to assess the short-term and long-term viability of depository institutions. On the basis of available information, we believe the depository institutions for which we broker deposits to be creditworthy.

We cannot reconcile the FDIC's statements and numbers with what we know about each of the FDIC-insured institutions and our insured CD program and the fact that the majority of such institutions have been assigned A or better ratings by the nationally recognized rating services. These institutions borrow billions of dollars daily on an unsecured basis from domestic and international investors because they are regarded as viable and creditworthy, not weak and risky as the FDIC has characterized them.

We have offered more than once to sit down with the FDIC to address these serious misunderstandings, since neither Merrill Lynch nor our customers want to own the CD's of institutions that are not viable and creditworthy. We extend that offer here again.

What I would like to cover today in the short time available to me is the brokered deposits market and Merrill Lynch's role, the impact of brokered deposits on the insurance funds, the harm that would result from the curtailment of deposit brokerage, and legislative alternatives under consideration.

I would like to make clear Merrill Lynch's position on brokered deposits. The brokering of medium-term insured deposits for individuals provides them with significant benefits and does not put the insurance funds at risk.

Merrill Lynch fully supports measures that would deal with the problems that do exist and are legitimate concerns of the agencies.

We oppose, however, unnecessary re-regulation and other actions that would eliminate depository options, reduce competition among banks and thrifts, and harm the economy.

Congress should adopt legislation which would: (1) Limit the access of weak depository institutions to brokered deposits; (2) limit the amount of short-term, insured brokered deposits per depository institution; (3) and most important, prohibit the agencies from adopting any rules which would have the effect of discriminating against depositors who rely on an intermediary.

Mr. Chairman, the Senate has before it a bill, S. 791, which would accomplish these objectives. It is similar to the Brokered Deposits Act of 1984, which was unanimously adopted by the Senate Banking Committee and which passed the Senate as part of last year's banking bill 89 to 5.

I would now like to discuss the three distinct brokered deposits markets. The oldest and largest market, with 53 percent of total brokered deposits, is the institutional investor uninsured market, which has existed since the early 1960's and is not directly related to the deposit brokerage controversy.

Another market, the smallest of the three, with 11 percent of total brokered deposits, is the institutional investor insured market. This market dates back to 1980 when insurance coverage was raised to $100,000 and is characterized by short-term maturities, typically less than 90 days. It has grown significantly since the 1982 Penn Square failure in which institutional investors were not able to recover their uninsured deposits. It consists of institutional investors spreading large deposits over a number of banks and thrifts in $100,000 pieces to achieve full insurance and high yields. The abuses usually referred to by the FDIC and the Bank Board have occurred in this market.

INDIVIDUAL SAVER INSURED MARKET

The third market, with 36 percent of total brokered deposits, is the individual-saver, insured market. It is served by multiservice brokerage firms like Merrill Lynch and does not need further regulation. We place deposits for individuals in average amounts of $14,000 with banks and thrifts. The deposits average 3 years in maturity and are frequently placed in IRA and Keogh accounts.

In a typical case a medium-size thrift would come to us with a request to raise, let's say, 5-year funds for residential mortgages. Our account executives would inform their customers about this particular CD offering, and over a period of several days or weeks they would place the full amount with a thrift. Later, because the CD's are negotiable, we may repurchase them without any interest penalty to the customers, and we sell them to other Merrill Lynch customers. Of course, from the time we buy back one customer's CD to the time we sell it to another, a day, a week or longer, Merrill Lynch owns the CD's and bears the risk.

That, Mr. Chairman, is how it works.

For each of its potential issuers Merrill Lynch conducts a credit review of regulatory and audited financial reports covering several years and has discussions and visits with management to evaluate funding and lending policies and management capabilities.

Although obviously Merrill Lynch cannot and does not guarantee in any way the creditworthiness of any issuer, we do assess an institution's short- and long-term viability. The process results in the rejection of over half of all interested banks and thrifts.

Merrill Lynch conducts such reviews before issuing insured or uninsured CD's for these reasons, among others. We want to deal only with quality institutions to assure our program's long-term success, and as a result of secondary market activity, we may hold up to $100 million in uninsured funds in our own account.

Next, Mr. Chairman, let me deal with the unsupported assertions of the agencies that deposit brokerage represents a misuse of Federal deposit insurance.

The deposit broker does not get the deposited funds; the funds go to the federally insured bank or thrift. Nor does the deposit broker get the Federal insurance; that goes to the depositor.

Congress intended that the individual is entitled to insurance coverage regardless of how the deposit is made. The courts agree with us. As Judge Gesell stated when he struck down the agency's rule limiting insurance on brokered deposits:

> The deposit broker regulations violate this central feature of the deposit insurance statutes by depriving individual depositors of the full measure of insurance protection mandated by the statute.

The abuses cited by the FDIC and the Federal Home Loan Bank Board concerning brokered deposits are almost always cases where an institutional investor's large short-term deposit is distributed among a number of institutions to obtain full insurance coverage, and in most cases the real culprit is uncontrolled growth by poorly capitalized institutions, or worse yet, bank or thrift mismanagement or fraud.

Over the last year several studies have found no causality between brokered funds and bank or thrift failures. If insured deposit brokerage is eliminated or severely curtailed, we can expect the following adverse effects:

First, millions of individual savers would lose access to competitive national rates, a variety of maturity options, and enhanced liquidity.

Second, well-managed banks and thrifts would lose a cost efficient, stable, and new source of medium-term, fixed-rate funds to restructure their balance sheets. Medium- and small-sized institutions would lose this important method for competing with the very large banks and thrifts which already have access to the national market.

Third, our economy as a whole would lose an important new source of capital for housing and an efficient way to move funds from capital surplus areas to capital deficient areas.

Finally, Mr. Chairman, I want to turn to the various alternative proposals put forth to deal with the problems connected with deposit brokerage.

The problems and imperfections that do exist in the brokered deposits market could, we believe, be effectively dealt with under existing supervisory powers and authority. Rather than dealing with these limited problems of deposit brokerage, however, the agencies have sought to destroy the market entirely. For instance, in March of last year the FDIC and the Bank Board jointly adopted a rule which would have virtually eliminated insured deposit brokerage. As you know, that rule has been struck down in the courts, but the agencies promise to continue to pursue it.

Another example: On May 7 the Bank Board published for comment a rule with such cumbersome and redundant recordkeeping requirements that the market for S&L CD's would be severely undermined. Like their earlier rule, this proposed rule is too sweeping and ignores existing arrangements which have proven to be valid and cost effective.

Merrill Lynch is deeply concerned that such actions by the agencies including their current legislative proposals, are intended, directly or indirectly, to eliminate deposit brokerage rather than deal with the actual problems that exist.

NO NEED FOR RESTRICTIVE REGULATIONS

The Barnard Committee studies have questioned the agencies' handling of this issue and offer alternative approaches which the regulators have yet to consider. These studies rely on information provided by the banking regulators. For example, the Comptroller of the Currency found that it is not in the best interest of the banking system to eliminate brokered deposits as a viable source of funds. The Barnard Committee reviewed the Comptroller's submission as well as other data and concluded that there is no need for severely restrictive regulation or legislation on brokered funds.

Mr. Chairman, S. 791 would deal effectively with the specific problems affecting deposit brokerage and eliminate any threat to the insurance funds from certain deposit brokerage activities, but this bill would preserve the rights of individual savers and the benefits of brokered deposits to well-managed banks and thrifts and to the economy as a whole.

Let me thank you and the other members of the subcommittee for allowing me to present Merrill Lynch's views and to briefly explain the importance of deposit brokerage. I will be happy to answer any questions you or your colleagues may have.

[The complete prepared statement follows:]

STATEMENT OF
EMANUEL J. FALZON, PRESIDENT
MERRILL LYNCH MONEY MARKETS INC.

I. Introduction

Mr. Chairman and distinguished members of the Subcommittee, I am Emanuel Falzon, President of Merrill Lynch Money Markets Inc., which is the nation's largest dealer in money market instruments such as commercial paper, bankers' acceptances and certificates of deposit. We place, on average, more than $1 billion per day in such instruments. I would like to thank you for giving me the opportunity to appear before you in connection with your deliberations over the important and complex issue of brokered deposits.

Before proceeding, let me make clear Merrill Lynch's position on brokered deposits. The brokering of medium-term insured deposits for individuals provides market access alternatives that might otherwise not be readily available. Deposit brokerage enables local and regional financial institutions to obtain access to funds that would, without such intermediary activities, be the sole preserve of larger competitors with national presence. Finally, deposit brokerage facilitates the efficient flow of capital to areas of need and into nationally favored assets, like housing. This all occurs without putting the insurance funds at risk.

At the outset, we agree that there are certain abuses in the deposit brokerage market -- specifically, in the institutional insured segment -- that need to be addressed by legislation. Merrill Lynch fully supports those measures now before the Senate that would deal with the problems that do exist and are legitimate concerns of the agencies. We oppose, however, unnecessary re-regulation and other actions that would eliminate depositor options, reduce competition among banks and thrifts and harm the economy.

Before giving you Merrill Lynch's recommendations concerning the various alternatives that may be considered in addressing the brokered deposits issue, I would like to review briefly (i) recent regulatory, legislative and judicial developments relating to deposit brokerage, (ii) the character of the brokered deposit market and its benefits, and (iii) two issues pertaining to the insurability of brokered deposits, namely, the minimal risks posed to the deposit insurance funds by deposit brokerage and the consistency of deposit brokerage with the legislative intent underlying the deposit insurance acts.

II. Background

On March 26, 1984, the Federal Deposit Insurance Corporation (the "FDIC") and the Federal Home Loan Bank Board (the "Board"), as operating head of the Federal Savings and Loan Insurance Corporation (the "FSLIC"), issued a rule (the "Invalidated Rule") which, had it taken effect, would have aggregated, and insured only up to $100,000 in the aggregate, all deposits placed by or through a deposit broker at a single insured depository institution, without regard to the number of beneficial owners of such deposits. Because the beneficial owner of a brokered deposit would effectively have been denied deposit insurance, the Invalidated Rule would have had the effect of virtually eliminating the brokerage of insured deposits.

On June 20, 1984, the United States District Court for the District of Columbia overturned the Invalidated Rule on the ground that the agencies lacked the statutory authority to promulgate the Invalidated Rule. On January 30, 1985, the United States Court of Appeals for the District of Columbia Circuit affirmed the District Court's decision.

As you know, since the June 20, 1984 decision, a number of bills dealing with brokered deposits have been introduced in both Houses of Congress. We believe that Senate bill 791* represents a constructive attempt to maintain the benefits provided by deposit brokerage while providing the agencies with the means to deal with those situations in which the misuse of deposit brokerage by unsound institutions can compromise the integrity of the deposit insurance funds.

Both the FDIC and the Board have sponsored legislation (H.R. 1680, H.R. 1833, S.759, S.760) which, while not directly limiting brokered deposits, would in effect give each agency broad new powers to promulgate rules, like the Invalidated Rule, to limit or eliminate deposit brokerage.

---

* The Senate passed a bill (S.2851) last year which, in relevant part, was virtually identical to S.791.

As will be made clear by my testimony, the Invalidated Rule would have had, and any future measures aimed at eliminating or significantly curtailing insured deposit brokerage will have, the effect of (i) denying individual savers the broadest possible choice of safe, liquid and competitively priced savings options, (ii) denying access to national markets and medium-term funds to sound depository institutions, particularly medium- and small-sized institutions, and (iii) eliminating the benefits which deposit brokerage has provided to the national economy. In general, the Invalidated Rule and similar measures represent an attempt to eliminate imperfections in the bank and thrift industry caused by deregulation through a sweeping and unnecessary regulatory or legislative intervention.

The primary reasons the FDIC and the Board have put forth in support of the Invalidated Rule and other measures to limit deposit brokerage is that deposit brokerage is perceived as a severe threat to the integrity of the federal deposit insurance funds. While the FDIC and the Board are properly concerned with the integrity of the insurance funds, deposit brokerage in and of itself does not pose a threat to the viability of the insurance funds. In fact, numerous governmental studies concerning the viability of the insurance funds have concluded that poor management of assets and vulnerability to high interest rates -- not deposit brokerage -- threaten the insurance funds. Deposit brokerage involving sound depository institutions actually strengthens the insurance funds by strengthening depository institutions and increasing the premium base of the insurance funds.

Deposit brokerage has provided many benefits to individual savers, depository institutions and the national economy. A simple "cost-benefit" analysis indicates that deposit brokerage should not be significantly curtailed.

The FDIC and the Board have also stated that deposit brokerage is a "misuse of the federal deposit insurance system" and that deposit insurance was "never intended to protect investors seeking the highest yields available in money markets". We believe deposit brokerage is fully consistent with the purposes Congress sought to achieve by creating the FDIC and the FSLIC and that, as the decisions of the District of Columbia District Court and the Court of Appeals recognize, all depositors were intended to be protected by deposit insurance up to the maximum amount irrespective of yield or method of deposit placement.

The primary benefit brokerage firms provide is inherent in their roles as financial intermediaries. As with other financial intermediaries, brokerage firms bring together persons wishing to deposit or invest money with those institutions seeking funds. By bringing together depository institutions and depositors and by maintaining a secondary market, brokerage firms have helped create a more efficient, nationwide market for deposit instruments. This market helps ensure that capital will flow from where it is available to where it is needed, thereby helping to maintain a viable national economy.

We recognize that certain abuses may have occurred in connection with deposit brokerage and believe that immediate action should be taken to eliminate those abuses. Merrill Lynch supports legislative solutions to such abuses which will both address the concerns associated with misuses of deposit brokerage and at the same time preserve the overall benefits of deposit brokerage to individual savers, depository institutions and the national economy. We also believe that certain of the solutions proposed -- such as limiting the percentage of short-term brokered deposits -- are far preferable to both the Invalidated Rule and the sweeping grant of power to the regulatory agencies that is contemplated in the legislation introduced on behalf of the FDIC and the Board.

III. The Brokered Certificate of Deposit Market

A. Market Structure

We believe that an understanding of the brokered deposit market is necessary in order to regulate or legislate the kind of change which will solve problems associated with certain parts of the market while maintaining the beneficial functions of the market. Moreover, an analysis of the brokered deposit market indicates that the "market" actually consists of three markets, and that the characteristics of the three markets have different implications for the issues being discussed today. The three distinct markets for brokered certificates of deposit("CDs") are as follows.*

Institutional Uninsured Certificates of Deposit. In this market, which has existed since the early 1960's, institutional investors such as money market funds, corporations, bank trust departments and insurance companies purchase CDs of the larger banks and a handful of the largest thrifts. The money center banks and large securities firms such as Salomon Brothers, Lehman Brothers, First Boston and Merrill Lynch participate in a secondary market which provides liquidity for investors. Approximately $100 billion in CDs in denominations of $100,000 and above are outstanding at any one time in this market, and approximately 40%-50% of the CDs in this market are placed by national brokerage firms. The average maturity is less than ninety days and the average transaction size is $5 million. Given this average transaction size, $100,000 of deposit insurance is obviously not important to the purchasers of these CDs.

---

* In Exhibit I, the markets described below are summarized.

It appears from the Invalidated Rule that the FDIC and the Board have not been concerned about this institutional uninsured certificate of deposit market. Nevertheless, the agencies have incorrectly included this segment of the brokered deposit market in issuing warnings about the size and growth of the brokered deposit market and the perceived resultant exposure to the insurance funds. Because these deposits do not expose the insurance funds to any significant degree of risk, it is misleading for the agencies to fail to differentiate this uninsured market from the insured brokered market in speaking of increased risks to the insurance funds.

For example, Penn Square Bank, N.A. was a participant in this uninsured certificate of deposit market. When it failed, the institutional uninsured depositors were the losers -- according to the FDIC's analysis of the Penn Square failure, over half of Penn Square's $465 million in deposits were uninsured. We understand that there were no insured brokered funds of individual savers in Penn Square. Even if brokered deposits had contributed to the failure of Penn Square, the Invalidated Rule would have done nothing to prevent its failure, since the bulk of the brokered deposits in Penn Square were uninsured.

Institutional Insured Certificates of Deposit. In 1980, the maximum FDIC/FSLIC insurance limit was raised to $100,000. Earlier, interest rate ceilings had been removed on deposits of $100,000 or more. These factors combined to cause the development of a market serviced for the most part by unregulated brokers who assist institutional investors in breaking up their funds into $100,000 fully insured pieces. Growth in this market accelerated after the Penn Square failure in 1982 as more institutional investors began to substitute full insurance protection for their own credit analysis.

The market in brokered institutional insured deposits is characterized by unregulated brokers dealing almost exclusively with institutional investors. The overwhelming majority of deposits in this market have short-term maturities and, to our knowledge, neither the brokers nor the institutional investors generally undertake credit analyses of the depository institutions involved. This is the market, therefore, that a troubled, cash-starved institution would look to for a quick infusion of funds at above-market rates, relying on deposit insurance.

We estimate the size of this market to be nearly $10 billion in CDs of banks and thrifts. While we believe that most of the funds in this market are going to sound depository institutions, we believe, based on conversations with the staffs of the FDIC and the Board as well as our knowledge of deposit brokerage, that the overwhelming majority of the brokered deposits of recently failed banks

---

and thrifts are part of this market -- short-term funds placed by unregulated money brokers on behalf of institutional investors.

Individual Insured Deposits. The individual insured deposit market came about approximately three years ago when the Depository Institutions Deregulation Committee ("DIDC") began to deregulate interest rates on time deposits of less than $100,000. DIDC also authorized these "deregulated CDs" to be issued in negotiable form. This negotiability feature permitted an active secondary market to develop in the individual deposit market and, combined with deregulated rates, provided individuals with the same benefits (liquidity and competitive market rates) that participants in the institutional deposit market had enjoyed for two decades. Negotiability obviously implied the participation of intermediaries such as bona fide brokers in this market, since depository institutions are effectively prohibited from making markets in their own time deposits.*

This market is serviced by the leading national brokerage firms (all of which are heavily regulated) and is dominated by deposits in relatively small denominations (individual savers' transactions average approximately $14,000) and maturities of over one year. A substantial amount of the deposits are placed with individuals pursuant to Individual Retirement Accounts ("IRAs") and Keogh plans.

---

* *See* 12 C.F.R. §217.159.

Because brokerage firms may at times maintain secondary markets for their investors in those CDs, the firms will often hold for their own accounts amounts well in excess of $100,000 of a single institution's CDs. The brokerage firms thus may be at risk with the banks and thrifts they represent since the CDs they hold are not fully insured. For example, as a result of secondary market activity, Merrill Lynch, may, at times, hold over $100 million of these CDs, including, in the case of one or more institutions, several million dollars worth of CDs. Each firm, therefore, of necessity conducts a credit analysis of prospective issuers (In Exhibit II, Merrill Lynch's credit procedures are summarized for the insured individual market). We conduct credit reviews of prospective issuers also to avoid jeopardizing our reputation of providing sound investments for our customers and to avoid subjecting our customers to the potential uncertainties and delays associated with FDIC and FSLIC payouts.

The relationship in this market between a bank or thrift and the national brokerage firm it selects is similar to that in other investment banking situations. Once the rate, commission, amount of issue and maturity of the CDs to be placed are established and a credit analysis of the depository institution has been completed, the brokerage firm begins marketing the bank or thrift offering through its distribution system. In this market, the brokerage firms compete for bank and thrift clients.

B. Benefits of Deposit Brokerage

The benefits deposit brokerage has provided to individual savers, depository institutions and the economy as a whole are considerable. Indeed, a simple "cost-benefit" analysis comparing the benefits to the minimal "costs" that could be associated with deposit brokerage* leads inescapably to the conclusion that deposit brokerage should not be eliminated. The benefits deposit brokerage provides include the following.

Individual Savers. The individual saver has received little mention in the discussion of insured deposit brokerage. Given current regulatory trends toward granting individuals freer access to financial markets, this is rather remarkable and represents a step backward. We have championed the cause of the individual, and we believe that the interests of this group need to be protected during the debate on deposit brokerage. This is the same group, after all, which for decades was denied the market rates available to institutional investors.

---

* See Exhibit III for two American Banker articles published in 1984 and 1985, respectively, in which the benefits and costs of deposit brokerage are discussed. The articles conclude that any problems associated with deposit brokerage can be addressed with minor reforms, and reject the agencies' solution in the form of the Invalidated Rule.

An important result of the availability to individual savers of brokered deposits is that the individual saver is able to participate in what has now become a national market for deposit instruments. The specific benefits individual depositors may receive are (1) more competitive rates (when local rates are not competitive), (2) wider choices of maturities (out to 14 years) at a fixed rate, and (3) enhanced liquidity. If federal insurance of brokered deposits is eliminated, the many benefits which deposit brokerage has provided the individual saver would be sacrificed.

As indicated by the number of individuals participating in this market, the individual saver has found access to the broader markets provided by deposit brokerage to be highly desirable. To date, more than one million people have purchased CDs through brokerage firms, frequently for inclusion in trust, IRA, Keogh and other custodial accounts. The removal of federal insurance of brokered deposits would virtually eliminate the brokered deposit as a choice for these people.

In summary, deposit brokerage has brought to individual savers the benefits which Congress envisioned they would enjoy when it created the DIDC in 1980 and instructed it to deregulate interest rates on deposits. Congress hoped that individuals would enjoy market rates of return, have many different deposit instruments to choose from and benefit from the liquidity of a secondary market. Through the brokerage of insured CDs, the goals of deregulation have been furthered. To eliminate brokerage of insured deposits to individuals would represent a step backward for deregulation.

Depository Institutions. Deposit brokerage activities have also resulted in substantial benefits to depository institutions. The benefits have been particularly important in the recent deregulatory environment in which small and medium-sized depository institutions have been compelled to compete for funds with the large money center banks and other financial institutions.

As a result of deposit brokerage activities, many creditworthy depository institutions are now better able than they were in the past to avail themselves of a national capital market in their effort to raise funds, both from institutional investors and from individuals. In this regard, curtailment of the brokered deposit market favors the largest financial institutions with massive intra- and interstate branch systems and the commensurate advertising and sales capability to reach a regional and national customer base. The elimination of federal insurance of brokered deposits would have the effect of destroying the national market in insured certificates of deposit and would deprive many small and medium-sized depository institutions of this cost-effective source of new funds, particularly for longer maturities.

In addition, deposit brokerage has significantly reduced the problem of disintermediation of funds from many depository institutions. A significant portion of the funds raised by depository institutions through brokerage firms has come directly from money market funds and other investment vehicles available through brokerage firms, providing net new funds to banks and thrifts. Such incremental funds to banks and thrifts have contributed to lower interest rates as well. If deposit brokerage were curtailed, individuals who have purchased deposit instruments made available by brokerage firms would resume placing their funds in alternative investments through the brokerage firms, thus resulting in a loss of funds to depository institutions.

Deposit brokerage programs have also provided one of the few cost-effective means for small and medium-sized banks and thrift institutions to raise medium-term deposits. The raising of medium-term deposits enables many depository institutions, especially thrift institutions, to fund their medium to long-term assets, such as housing loans. This practice of "matched funding" fosters strength and stability in depository institutions.

In addition, many knowledgeable observers of the thrift industry have concluded that the single greatest threat to thrift institutions is the vulnerability of thrifts to higher interest rates. To reduce interest rate vulnerability, thrifts need to "restructure" their balance sheets by taking more long-term deposits. Last year, a study of the thrift industry indicated that over $300 billion of short-term thrift liabilities were being used to fund long-term assets. The restriction of deposit brokerage without distinction between short-term and longer-term deposits would limit access to one of the best balance sheet restructuring tools currently available to thrifts -- just when they need it most.

Fears have been expressed that, due to deposit brokerage, depository institutions will become "hostage to" deposit brokers. Given the competitive nature of the various funding markets for healthy depository institutions, the fear that depository institutions would become overly reliant upon brokered deposits is far-fetched. Healthy institutions have access to many sources of funds, and a well managed depository institution will never become overly reliant on (or a "hostage to") any single funding alternative. For years, money center banks and large thrifts have been using brokered deposits without provoking this concern (up to 40% of the deposits of some money center banks are raised by intermediaries). To raise the "hostage" issue as a concern for the individual negotiable CD market slights the judgment and credibility of bank and thrift management.

A fear has also been expressed that brokerage firms will control the pricing of deposit instruments. This is ridiculous. Interest rates on deposit instruments placed by brokerage firms are set by the marketplace, exactly as in the case of other financial instruments. If interest rates are too high, banks and thrifts will not issue deposits; conversely, if rates are too low, savers will not deposit funds.

The average rates on deposit instruments offered through Merrill Lynch are comparable to national rates. As would be expected in any free market, rates on CDs offered through national brokerage firms are generally lower than rates offered by depository institutions directly in capital deficit areas, and generally higher than local depository institutions offer directly in capital surplus areas. The interest rates on brokered deposits offered to individuals closely track the interest rates of United States government and agency obligations of comparable maturities.

The Economy. Deposit brokerage provides depository institutions with an additional, stable source of funds which may be used to increase the amount of funds available for housing loans. The removal of insurance of brokered deposits would thus eliminate an important source of funds for housing loans. This may have the effect of causing interest rates on housing loans to rise as these funds become more scarce.

In addition, as the Federal Reserve Board and other industry observers have noted, deposit brokerage has performed the important function of moving funds from areas of excess savings to areas in need of funding for the legitimate banking and credit needs of consumers and businesses. Thus, shutting down the market in insured brokered CDs would impair the efficiency of the nation's credit and savings markets by artificially restricting the flow of capital from where it is available to where it is needed. An additional effect of the elimination of deposit insurance of brokered deposits would be to increase the concentration of deposits in the largest banks, which currently are able to raise deposits nationally.

The Board has indicated that existing funding mechanisms, in particular Federal Home Loan Bank borrowings, will be able to meet the medium- and long-term funding needs of thrifts if insured deposit brokerage is eliminated. However, reducing the number and kinds of funding alternatives is economically inefficient. Federal Home Loan Bank borrowings are not, in general, a low-cost funding option* and our experience suggests that such funds are, at certain times and for certain maturities, more costly. At times brokered deposits are the most cost effective choice.

---

* "Since the rate S&Ls have to pay on FHLB loans is set sufficiently high to cover the FHLB's borrowing cost, such loans are not a cheap source of funds to S&Ls." The Money Market, Revised Edition 1983, Marcia Stigum, Dow Jones-Irwin, p. 216.

If federal insurance of brokered deposits is eliminated, or if the brokered deposit market is significantly curtailed, competition among depository institutions would diminish. Small and medium-sized institutions will not be able to compete effectively with large institutions in their effort to attract funds. This, in turn, will make it more difficult for small and medium-sized institutions to compete for lending opportunities with large institutions since the smaller institutions will lack the funding required for these loans. This could result in a further concentration of assets in these larger institutions. In addition, diminished competition in the deposit market will undoubtedly lead to less competitive rates on deposits being offered by the remaining participants in that market.*

IV. Insurability of Brokered Deposits

Any resolution of the brokered deposits question must address both the risks posed to the federal deposit insurance funds by the practice and the consistency of any proposed resolutions with the purposes of having a federal deposit insurance system. Merrill Lynch believes that the action and statements of the FDIC and the Board evidence an inflated estimate of the risks posed to the funds by deposit brokerage. In addition, Merrill Lynch believes that, because deposit brokerage is fully consistent with the deposit insurance acts, curtailment of deposit brokerage will not further the interests intended to be served by the deposit insurance system.

---

* In a comment letter submitted to the agencies by the Department of Justice, the Department concluded that enactment of the then-proposed Invalidated Rule would have "seriously damage[d] competition and [been] wholly unwarranted".

A. Minimal Risks Posed by Deposit Brokerage

The continuing efforts of the FDIC and the Board to eliminate federal insurance of brokered deposits and to otherwise restrict the deposit brokerage business evidence a failure to recognize the differences among the three brokered deposit markets -- particularly the profound differences between the two insured markets -- and the enormous benefits provided by deposit brokerage.

As a result of not understanding the brokered deposit market, the agencies have reached erroneous conclusions about deposit brokerage. The Board's projection of the growth rate for brokered deposits is, as discussed below, contradicted by market reality. Also, in speaking of the risks to the insurance funds posed by deposit brokerage, the agencies have failed to recognize that only insured deposits, which are the smaller part of the brokered deposit market, are relevant to the integrity of the deposit insurance funds.

The agencies have also failed to recognize that brokered deposits of individual savers are not a cause of financial instability at depository institutions. To the agencies, all brokered deposits are the same, whereas the brokered deposit market teaches us they are not. We fail to see how it makes sense to effectively eliminate the brokerage of insured deposits to individuals since this practice has not been associated with any of the problems the FDIC and the Board have attributed to deposit brokerage. On the contrary, the brokerage of insured deposits to individual savers actually strengthens depository institutions.

Recently, the Board proposed to revise its record-keeping requirements with respect to accounts at FSLIC-insured institutions.* While some of the changes proposed by the Board would serve to clarify existing regulations, portions of the proposed regulations, for which the Board has provided no cogent justification, would curtail or eliminate a number of effective and economical current arrangements through which significant amounts of negotiable deposits in FSLIC-insured institutions, including a substantial amount of brokered funds, currently are held. This would cause particular harm to the market involving small, individual depositors.

---

* 50 Fed. Reg. 19185 (May 7, 1985).

We have asked ourselves why the agencies chose to propose a rule which was clearly too broad for the purposes it was intended to serve and why the agencies have continued to oppose reasonable efforts to address the brokered deposits issue. The only conclusion that we have been able to reach is that the FDIC and the Board are seeking to exclude bona fide brokers from deposit brokerage at any cost, regardless of the expense of depositors, the safety of the very institutions the agencies seek to protect, and the economy.

Invalidity of Board's Projections. In a speech made in January 1984, Board Chairman Edwin Gray suggested that, by the end of 1985, one-third of all deposits at FSLIC-insured institutions, or more than $260 billion, would be in federally insured, money brokered funds. This projection was intended to demonstrate the magnitude of the threat to the funds. Merrill Lynch estimated at the time that fully insured brokered deposits at FSLIC-insured institutions held by individual savers might reach $24 billion by December 1985.

In Exhibit IV, we contrast the two projections. Because the growth rate of brokered deposits has flattened over the past year, it appears that Merrill Lynch's projection will be much closer to the actual figures than Chairman Gray's. (See Exhibit V)

Results of Studies on Deposit Brokerage. The avowed purpose of the agencies in promulgating the Invalidated Rule and in their efforts to obtain increased regulatory authority has been to protect the deposit insurance funds from the risks perceived to be posed by deposit brokerage. However, a September 1984 report by the Subcommittee on Commerce, Consumer and Monetary Affairs of the House Committee on Government Operations, as well as an April 1985 study prepared by the Subcommittee's chief economist, cast serious doubt on the view that deposit brokerage poses a threat to the funds. Among the findings reached in the April study were that (i) among commercial banks, abusive use of brokered funds is generally limited to small institutions, (ii) brokered funding was declining "dramatically" as a factor in recent bank failures, (iii) with respect to savings and loans, the regulators can control excessive brokered funding growth by problem institutions through supervisory means alone, without imposing harsh new regulations or legislation, and (iv) the Board, in response to a Subcommittee request, failed to find any systematic difference between cases of problem institutions that relied upon brokered funding for their growth and those that did not, except that so-called "linked financing" (situations where a deposit broker might suggest or require that the proceeds of brokered funds be put to specified uses) appeared to be present in several brokered funds cases. Both reports are included in Exhibit VI.

The agencies, and the FDIC in particular, would probably disagree with the foregoing conclusions despite the fact that they supplied the data used in the analyses. The FDIC continues to overstate the amount of fully insured CDs, erroneously including largely uninsured (over $100,000) CDs from the institutional market.

Indeed, it is almost impossible to reconcile the public statements of the FDIC with the data provided by the Comptroller of the Currency and the following conclusion drawn by the House Subcommittee.

> The figure of "$9+ billion" that has frequently been cited by the FDIC as the amount of brokered funds in "troubled" banks (CAMEL-rated 3, 4 or 5) has no meaning or relevance as an indicator of the size of the brokered funds problem. As of September 30, $8 billion of this amount was held by 13 or 14 large national banks whose "troubled" classification had nothing to do with their reliance on brokered funding, according to the Comptroller of the Currency. Most of this $8 billion in brokered funds was uninsured anyway.

Moreover, attempts have been made to use faulty data, such as the "$9+ billion" figure cited above, to cast doubt on Merrill Lynch's evaluation process and suggest that Merrill Lynch and other deposit brokers have placed large amounts of fully insured deposits with "troubled" institutions (presumably based on the CAMEL scale).

Merrill Lynch considers the banks that it represents in both the insured and uninsured markets to be viable, creditworthy institutions. While we have not and cannot respond to charges relating to CAMEL ratings -- since these are not publicly available -- we do have a rigorous evaluation system of our own, which may not be identical to the supervisory system, but which allows us to assess an institution's viability over the term of the deposits it seeks to raise.

Finally, it is particularly difficult to reconcile the FDIC's statements with the fact that the majority of the banks that Merrill Lynch represents in the insured CD market are either directly rated or are subsidiaries of bank holding companies which are rated "A" or higher by nationally recognized rating agencies (namely, Standard & Poor's, Moody's and Fitch Investors Service). If the FDIC has any damaging information on a bank that contradicts these ratings, it ought to disclose specific information about specific institutions to the investing public and the brokerage community, and not obscure such problems in highly aggregated numbers and technical terms such as "problem" or "troubled", which serve only to confuse the investing public. Alternatively, if the FDIC regards public disclosure as undesirable, it could simply prohibit or carefully limit deposit growth of any kind at an institution failing to meet specified standards. As we have repeatedly informed the FDIC, neither Merrill Lynch nor the rest of the Wall Street dealer community want to be involved with any institution which is not creditworthy.

The agencies' conclusions also conflict with a January 1985 study by Cates Consulting Analysts, which covered a group of 1984 bank and thrift failures. The Cates study, conducted for Merrill Lynch, found that the causes of failure remain "asset quality risk" in banks and "interest rate risk" in thrifts. The full study, which analyzed numerous financial ratios in five risk categories, is included in Exhibit VII.

Further doubt about the agencies' conclusions arises from a November 1984 Federal Reserve Board research paper entitled "Brokered Deposits and Bank Soundness: Evidence and Regulatory Implications." Although the paper found a correlation between the use of brokered funds and weak financial performance, it acknowledged that "of course, correlation does not prove causality."

Authority to Curtail Deposit Expansion. While unrestrained deposit growth by weak institutions making imprudent asset decisions increases the exposure of the insurance funds, insured deposit brokerage in and of itself does not. There are numerous examples of weak banks and thrifts excessively stimulating deposit growth by means other than deposit brokerage. For example, banks and thrifts can raise deposits rapidly by offering above-market rates in their local areas and by using direct mail or other advertising to attract out-of-state funds.

The agencies' current regulatory authority provides the regulators with more than adequate authority to curb unwise deposit growth -- including the improper use of the brokered deposit market -- and the agencies should utilize this authority. Given that fact, one wonders why the agencies continue to press for the abolition of insured deposit brokerage.*

Causes of Bank and Thrift Failures. The FDIC and the Board often cite instances in which recently-failed depository institutions have a higher-than-average percentage of brokered deposits. What the agencies fail to point out is that these are isolated cases in which almost all the brokered deposits are short-term deposits obtained from institutional investors participating in the institutional insured market described earlier.

Moreover, the FDIC and the Board have failed to recognize that it is not deposit brokerage which is the culprit in these cases but rather mismangement, and in some cases, fraud. Over the last year several studies have found no causality between brokered funds and bank or thrift failures.

---

* The April 1985 House Subcommittee staff study mentioned above concluded that "[T]here is room for major improvement in the enforcement of existing Bank Board rules."

B. Deposit Brokerage is Consistent with the Insurance Acts

In promulgating the Invalidated Rule, the FDIC and the Board stated that deposit brokerage is an "outright misuse of the federal deposit insurance system" and that deposit insurance "was never intended to protect investors seeking the highest yields available in money markets." This idea, that somehow deposit brokerage is a perversion of the intent of Congress when it established deposit insurance, has been at the root of the agencies' continuing efforts to curtail deposit brokerage activities. However, the legislative history of the Federal deposit insurance acts reveals that, contrary to the position taken by the FDIC and the Board, brokerage of insured deposits serves the very purposes intended to be served by the Federal deposit insurance system.

Purposes of Deposit Insurance. The legislative history of Federal deposit insurance reveals that deposit insurance would serve three primary purposes. First, deposit insurance is intended to promote confidence in the banking system in general in order to attract as many deposits as possible to banks and thrifts. Second, while deposit insurance is intended to attract deposits to the banking system in general, we believe that Congress has been particularly concerned with maintaining public confidence in, and attracting deposits to, small- and medium-sized depository institutions. Third, deposit insurance is intended to protect individual depositors from suffering losses of their savings.

Deposit brokerage is consistent with all three purposes underlying the Federal deposit insurance system.

Deposit brokerage of insured deposit instruments clearly serves the purpose of attracting depositors to depository institutions. It has been our experience that a significant portion of the funds raised by nationally recognized brokerage firms has come directly from money market funds and other investment vehicles made available by brokerage firms. Thus, deposit brokerage of insured deposits has provided net new funds to banks and thrifts.

As discussed above, deposit brokerage activities have also provided many benefits to small- and medium-sized banks and thrifts. Primarily, these benefits are access to a national deposit market, access to medium- to long-term deposits and increased competition with money center banks.

With respect to the protection of depositors, it is important to note that many individuals have deposited funds with banks and thrifts through deposit brokers. These individuals are precisely the type of depositors Congress intended to be protected by the deposit insurance legislation.

Thus, we believe the brokerage of deposits is consistent with the Congressional purpose of protecting depositors.

Insurance on High Yield Deposits. In promulgating the Invalidated Rule, the agencies stated that "deposit insurance was never intended to protect investors seeking the highest yields." The legislative history of the deposit insurance acts, however, provides no support for this assertion. Rather, to the limited extent that the legislative history deals with the question of whether depositors seeking high yields on deposits should be entitled to deposit insurance, the legislative history supports the availability of insurance to those depositors. The language of the District Court's decision, in overturning the Invalidated Rule, also supports this conclusion.*

The recent deregulation of interest rates effected by the DIDC, acting pursuant to a Congressional mandate, indicates that Congress intended to accord deposit insurance to individuals seeking money market rates. Indeed, one of the purposes of the deregulation legislation (and DIDC actions taken pursuant thereto) was to enable depositors to shop for insured account rates that were competitive with rates being paid by money market funds.

---

* In reaching his decision, Judge Gesell stated "It is clear, therefore, that the statutes were intended to grant to each depositor federal insurance up to the statutory ceiling..." (Emphasis not added).

For some reason, the agencies have expressed the view that persons who utilize a brokerage firm to place deposits are "investors" and not depositors and, as brokerage firm customers, do not merit insurance. However, anyone who deposits money in a depository institution, whether directly or through a brokerage firm, is a depositor. The individuals who make their deposits through brokerage firms are just as entitled to deposit insurance as persons making deposits directly with depository institutions.

"Marketing" of Deposit Insurance. The agencies have also, from time to time, deplored the "marketing" of deposit insurance by brokers. Evidently there is a basic belief by the agencies that deposit brokers should not be able to offer an instrument which is federally guaranteed.

Of course, this notion is unfounded. For decades, intermediaries such as brokerage firms have been making a market in government or government guaranteed obligations, such as Treasury Bills, Government National Mortgage Association obligations and Federal National Mortgage Association obligations.

Somehow the agencies have seemingly become convinced that the brokerage firm is reaping the benefits of deposit insurance. Yet the brokerage firm neither gets the deposited funds -- which go to the depository institution -- nor the deposit insurance -- which, of course, goes to the depositor. The brokerage firm merely brings depositor and depository institution together and charges a fee, like any other intermediary, for its services.

Statutory Authority. The District Court decision overturning the Invalidated Rule and the affirmation of that decision on appeal confirmed the correctness of our view that the promulgation of the Invalidated Rule exceeded the agencies' authority. Congress alone has the power to effect changes of the type contemplated in the Invalidated Rule. The reason we are here today is to support Congressional efforts to address the deposit brokerage issue in a reasonable and constructive fashion.

V. Alternatives under Consideration

As stated above, we believe there have been abuses in the insured brokered deposit market by unregulated brokers that deal almost exclusively with institutional investors. Such abuses can be prevented by prudent legislative action addressed to those activities that result in abuse, rather than those activities that provide the benefits we have detailed in this Statement.

Prudent legislation in this area should have the following objectives:

Prohibit Weak Institutions from Accepting Brokered Deposits. Institutions that do not have the capacity to absorb and carefully invest brokered funds should not be allowed to accept such funds. Thus, depository institutions that have a net worth below the level prescribed by the applicable regulatory body should be prohibited from accepting brokered deposits.

Limit the Amount of Short Term Brokered Funds an Institution Can Accept. The greatest abuses occur when depository institutions accept large amounts of brokered deposits that have maturity dates of less than one year. This compels the institution to obtain a relatively quick return on its money in order to pay back the deposits, plus interest, and make a profit. The types of investments providing a quick return may be risky and unsound. On the other hand, medium- and long-term deposits allow the institution to fund its medium- and long-term assets, such as housing loans, while giving the institution a stable deposit base.

Prohibit Discrimination Against Holders of Brokered Deposits. In order to ensure that deposit insurance is extended to brokered deposits consistent with the mandates of the deposit insurance laws, the FDIC and the Board should be prohibited from discriminating against brokered deposits in providing deposit insurance. Such a prohibition would proscribe regulations like the Board's proposed recordkeeping rule which, in effect, imposes unreasonable and unrealistic requirements designed to make deposit brokerage uneconomical.

Legislation containing the provisions we believe necessary for effective regulation of deposit brokerage was approved last year by the Senate Banking Committee and the Senate as part of S.2851. This year Senators D'Amato and Mattingly have introduced a bill (S.791) which is an intelligent, well-crafted piece of legislation that incorporates the concepts outlined above. We applaud and support their efforts. In Exhibit VIII, we provide a thorough discussion of why this kind of legislation would be appropriate.

There are other proposals for regulating the brokered deposits market. One such proposal, introduced by Congressman Wylie in H.R.15, would place a cap on the acceptance of insured brokered deposits at 5% of total deposits. Such a proposal fails to make the critical distinction between short-term and long-term brokered deposits and, thereby, effectively denies sound depository institutions the benefits of brokered deposits with maturities of more than one year when these deposits have not been associated with any abuses or problems. Furthermore, while any cap is necessarily arbitrary, a 5% cap is unrealistically low, even if the cap is on short-term brokered deposits alone.

The Board has also proposed legislation addressing brokered deposits. Its proposal, embodied in S.759, would provide the Board with authority to establish classes of accounts and determine which classes are entitled to deposit insurance. In the accompanying analysis of its proposed legislation, the Board makes clear that the legislation is designed to give it the authority to promulgate the Invalidated Rule. We strongly oppose any legislation that would give the Board or the FDIC authority to eliminate insurance of brokered deposits. The destruction of the deposit brokerage market, which would be the result of eliminating insurance, would be harmful to all depository institutions in this country and to the consumers they serve.

A final alternative would be to do nothing. We believed for a long time that application of the current statutes, combined with effective enforcement action by the two agencies, would have been the best solution. However, in view of the agencies' efforts to curtail deposit brokerage such as the Invalidated Rule and the Board's recordkeeping rule, we believe that legislative action is necessary to preserve brokered deposits. Accordingly, we support the adoption of reasonable legislative alternatives, such as S.791, which would control any abuses that may exist while preserving the many positive aspects of deposit brokerage.

VI. Conclusion

Merrill Lynch recognizes that there are some abuses associated with the improper use of brokered deposits.

To deal with these abuses, Merrill Lynch urges the Congress to adopt legislation which would, first, limit the access of weak depository institutions to brokered deposits; second, limit at a reasonable level the amount of short-term insured brokered deposits per depository institution; third, and most important, prohibit the agencies from adopting any rules which would have the effect of discriminating against depositors who rely on an intermediary such as a deposit broker.

These recommendations are workable and would deal effectively with the specific problems in the market and eliminate any conceivable threat to the insurance funds from deposit brokerage activities. They would also preserve the rights of individual savers and the benefits of brokered deposits for well-managed banks and thrifts and for the economy as a whole.

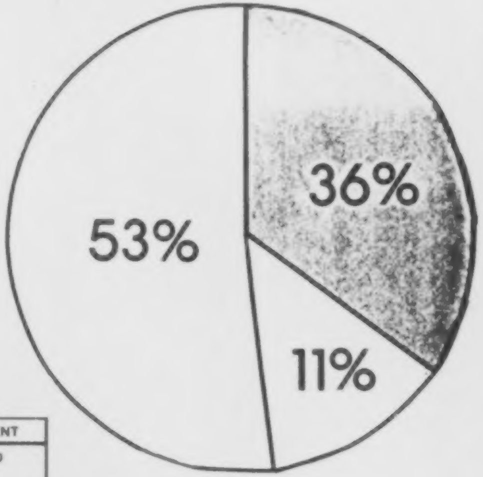
The Senate has before it a bill (S.791) which we believe would accomplish these objectives. It is similar to the Brokered Deposits Act of 1984 which was passed unanimously by the Senate Banking Committee and was passed by the Senate as part of S.2851, 89 to 5, in the last session.

Merrill Lynch hopes that this Statement will help reinforce the Senate's commitment to legislation that will solve the existing problems associated with deposit brokerage while maintaining the many benefits of brokered deposits.

EXHIBIT I

THE BROKERED DEPOSIT MARKET

TOTAL BROKERED DEPOSITS
$88 BILLION AT BANKS AND THRIFTS
DECEMBER 1984



[illegible] INSURED SEGMENT	
ISSUERS:	LARGE, MEDIUM SIZE AND SMALL BANKS AND THRIFTS
DEALERS:	NATIONAL BROKERAGE FIRMS
CUSTOMERS:	INDIVIDUAL SAVERS INCLUDING IRA/KEOGH ACCOUNT HOLDERS
CREDIT REVIEW:	CAREFUL REVIEW BY BROKER-DEALER
AVERAGE MATURITY:	OVER 3 YEARS
OUTSTANDINGS:	$32 BILLION

INSTITUTIONAL UNINSURED SEGMENT	
ISSUERS:	LARGE BANKS AND THRIFTS
DEALERS:	MONEY CENTER BANKS AND NATIONAL BROKERAGE FIRMS
CUSTOMERS:	LARGE INSTITUTIONAL INVESTORS
CREDIT REVIEW:	CAREFUL REVIEW BY BOTH DEALER AND INVESTOR
AVERAGE MATURITY:	90 DAYS
OUTSTANDINGS:	$46 BILLION

INSTITUTIONAL INSURED SEGMENT	
ISSUERS:	SMALL BANKS AND THRIFTS
DEALERS:	UNREGISTERED "MONEY BROKERS"
CUSTOMERS:	MEDIUM AND SMALL INSTITUTIONAL INVESTORS
CREDIT REVIEW:	NONE USUALLY
AVERAGE MATURITY:	90 DAYS
OUTSTANDINGS:	$10 BILLION

SOURCE: MERRILL LYNCH ESTIMATES AND ANALYSIS.

EXHIBIT II

MERRILL LYNCH CORPORATE CREDIT STANDARDS

CORPORATE CREDIT STANDARDS*
INSURED RETAIL CERTIFICATES OF DEPOSIT

I. It is Merrill Lynch's policy to deal only with depository institutions deemed appropriate according to the following standards:

   A. Review of the institution's financial condition and management indicates

      1. for all issuers, strong near-term viability, and

      2. for issuers of longer-term deposits, no clear, present threat to longer-term viability.

   Institutions exhibiting rapid growth of risk assets are generally considered unfavorably.

   B. The institution's franchise is such that, in the event of a failure, an assumption of liabilities is more likely than liquidation.

II. Review of each institution includes:

   A. Collection of regulatory and audited financial reports covering a period of the last several years up to the most recent calendar quarter, plus other data as may be required by the Corporate Credit Analyst.

   B. Analysis of:

      1. capital adequacy (which includes review of the level and trend of capital ratios, as well as the composition of capital);

      2. profitability (which includes not only the level but the quality and trend of earnings as well as review of the components of earnings and near-term earnings prospects);

      3. asset quality (which includes not only review of current problems but also the analyst's view of possible changes in asset quality based on (a) composition of and changes in portfolio mix and (b) general economic conditions);

      4. liquidity (which includes a review of liquid assets as well as types and stability of funds sources);

      5. the institution's exposure to interest rates;

      6. the length of time the institution has been in business, and the length of time current management/ownership has been in control;

      7. the size of the institution, since larger companies

         (a) are less likely to be overwhelmed by local economic factors,

         (b) are less likely to change radically the nature of their business,

         (c) have greater flexibility should problems occur, and

         (d) are more likely to receive needed regulatory attention in a crisis.

   C. Discussions with management covering key management policies, e.g., with respect to loan review, liquidity, asset-liability management, and key strategies, e.g., for expansion into new markets.

   D. Statement from management as to use of proceeds.

III. Corporate Credit will place a limit on the amount of deposits to be placed depending on the overall quality of the institution, the distribution of maturities and the use of proceeds.

---

* Excerpted from internal Merrill Lynch Corporate Credit Policy Bulletins.

EXHIBIT III

AMERICAN BANKER REPRINTS

MARCH 20, 1984 "IN PRAISE OF BROKERED DEPOSITS"

FEBRUARY 26, 1985 "REFOCUSING ON BROKERED DEPOSITS"

American Banker
The Only Daily Banking Newspaper

VOL. CXLIX NO. 56 Tuesday, March 20, 1984 149th Year

Comment

In Praise of Brokered Deposits

By SANFORD ROSE

The FDIC and the FHLBB want to restrict to $100,000 the insurance coverage on deposits placed by or through a deposit broker at a single depository institution, regardless of the number of beneficial owners of those deposits. This per-broker, per-institution limit would obviously kill the market in brokered insured deposits. Some regulatory agencies apparently think that this is desirable. But they are gravely mistaken.

The total brokered deposit market, estimated at around $80 billion, consists of three components: 1) the institutional market in uninsured CDs, 2) the institutional market in insured CDs, and 3) the noninstitutional market in insured CDs. Component one — the brokerage of over-$100,000 CDs — would be largely unaffected by the FDIC-FHLBB proposal. Components two and three would be affected.

It may be legitimate to choke off the institutional market in insured CDs, estimated at around $6 billion. That market is run by unregulated brokers who slice up the deposits of wholesale investors into bundles of $100,000 or less and parcel these out to hungry banks and thrifts. One can legitimately argue that this is a misuse of deposit insurance, which was never intended to benefit large investors just because they may be nimble enough to subdivide their holdings.

What's more, it has been established that the brokers operating this market do little or no credit analysis. This is a somewhat irrelevant but nonetheless highly emotive point. The fact that an intermediary will accept CD issuers solely on the basis of yield and without assessing their soundness conjures up an image of insouciant greed that predisposes the public to accept regulation.

However, the attempt to lump brokers who serve the needs of institutional investors with those who serve the needs of retail savers makes no sense at all. The noninstitutional insured part of the brokered deposit market, estimated at around $16 billion, is populated with registered brokers who profess to do adequate credit analysis and whose activities are not in the least inconsistent with the objectives of the deposit insurance system.

Performing a Classic Chore

Brokers of retail CDs — chiefly Merrill Lynch, which has placed over $10 billion in paper within the last year — perform the classic role of helping to liberate individual savers from the confines of geography. They move funds from capital surplus to capital deficit areas, offering savers from the surfeited region the opportunity to earn somewhat higher returns than are available locally.

For example, the average rate on one-year CDs brokered by Merrill in the fourth quarter of 1983 was higher than that posted by the major banks in such capital surplus areas as Chicago, Detroit, and Philadelphia.

Additionally, the insured CD broker offers the saver a wider choice of maturities than he currently enjoys. Because of its extensive institutional coverage, a broker like Merrill can provide the saver with maturity options extending out as long as 13 years and often unavailable from banks and thrifts in his local area.

Brokerage can also broaden product options. The zero-coupon CD is a superior investment vehicle. It is, in fact, the only form of long-term bank deposit that provides a guaranteed yield. That's because there is no interest withdrawal and the return is compounded at the promised yield until maturity.

Savers desirous of purchasing zero-coupon CDs frequently can't find banks or thrifts that offer them. Merrill Lynch has identified a number of institutions that understand the need for zero-coupon vehicles, and it can therefore accommodate knowledgeable customers.

(Approximately 8% to 10% of the more than $10 billion in CDs Merrill Lynch brokered in the last year have been in zero-coupon form. The face amount of these CDs, as opposed to their discounted amount, approaches $2.5 billion.)

A Glimpse of Future Benefits

The case of the zero-coupon CD suggests how important deposit brokers may eventually become — provided the regulators don't kill the market. The zero, of course, provides advantages to issuers as well as to savers. Since there is only one cash flow, paid at maturity, the zero has a duration that is exactly equal to its maturity.

Many bank and thrift assets, however, have multiple cash inflows. Since the present value of the later cash inflows is much less than that of the earlier cash inflows, the composite durations of these assets are appreciably shorter than their maturities.

Banks and thrifts are beginning to realize that they can make long-term fixed-rate loans with deposits of much shorter maturity than the loans — without assuming interest risk. That's provided the duration — not the maturity — of the assets approximates the duration of the liabilities.

Since a 30-year fixed-rate mortgage made at today's rates has a duration of around five years, it must be funded with a CD of similar duration. And since zero-coupon CDs have durations that are identical to their maturities, a 30-year mortgage can be funded safely with a five-year deposit, provided that deposit is a zero-coupon instrument.

Now, even when a bank or thrift catches on to this fact, it often cannot capitalize on it because of marketing limitations. It may require considerable advertising dollars to acquaint savers in any given area with the virtues of the zero-coupon instrument. The local institutions may not be able to spend those dollars.

Merrill Lynch can, and it also has a clientele of sophisticated savers who very often don't need much persuading. So Merrill and its competitor brokers are logical handmaidens of the banking and thrift industry. Their capacity to tap funds from a variety of sources may enable institutions in even the most isolated areas to reintroduce the long-term fixed-rate loan that is retained in portfolio yet does not increase the institution's interest rate exposure — provided the duration match of the portfolio is continuously monitored.

Virtues of the Secondary Market

The deposit broker contributes to the institution's capacity to service the demand for fixed-rate credit is still another way. Brokers like Merrill Lynch make a secondary as well as a primary market in retail CDs. The primary CDs that the firm brokers are negotiable, but they are not redeemable before maturity. Hence if the saver wants to get to cash, he must sell the instrument back to Merrill, garnering a profit if rates have fallen since his purchase or a loss if rates have risen.

Relatively few savers have thus far made use of secondary-market facilities. But if banks and thrifts imposed realistic premature withdrawal penalties — say, forfeiture of as much as one year's interest on a multiyear CD instead of today's nugatory penalties, which in effect give the saver a "par put" on the issuing institution — customer interest in using the secondary market would, of course, be heightened.

Consider the consequences of what might happen if banks and thrifts began imposing realistic penalties for premature withdrawal. The institutions would be reasonably sure that long-term funds, once acquired, would remain long term, regardless of what happened to interest rates. Instead of redeeming their CDs at the institutions of issue, savers would use the secondary market whenever they wanted to get to cash. No matter how many times a long-term instrument was sold and resold in that market, it would remain the obligation of the issuing institution.

Secure in the knowledge that their longer-term funds cannot suddenly be transformed into shorter-term obligations, depository institutions would become far more disposed to extend long-term credit than they now are. The needs of borrowers would be better served than is now the case, while the saver would still be afforded the opportunity to liquefy his holdings.

The price the saver pays for liquidity would depend on how quickly he moved. Conceivably, savers would soon become acclimated to moving with great celerity, taking small losses when rates rose and small profits when rates declined.

The FDIC-FHLBB proposal to limit to $100,000 the insurance coverage on deposits handled by a given broker for a given institution would eliminate the secondary as well as the primary market in brokered insured deposits. And since, in the opinion of many, depository institutions are precluded from making a market in their own time deposits, the proposal would effectively nullify the negotiability option on retail CDs granted to depository institutions by the DIDC two years ago.

The FDIC-FHLBB initiative would therefore weaken the profit potential of many institutions and decrease the overall efficiency of financial intermediation. One would have to assume that the regulators have very compelling motives for taking such a step. But is that in fact the case?

Presumably, the regulators want to prevent poorly run institutions from acquiring through brokerage the deposit wherewithal to expand footings and thus increase the risk to the insurance funds. That sounds like a perfectly sound objective, but surely it can be achieved by other methods than the destruction of the market in brokered insured funds.

The deposit brokers are perfectly willing to report to the regulators on a monthly or even a weekly basis, advising as to which institutions have received what amount of funds. If the regulators are reluctant to sanction the growth of certain institutions that might misallocate brokered funds, then they can quite simply order the affected banks and thrifts not to acquire those funds.

Can the regulators identify potential regulatory risks far enough in advance? Of course they can — or at least they should be able to make such a determination.

The regulators are cutting back on the number and frequency of examinations of sound depository institutions in order to concentrate their manpower on those that are potential risks. Computer surveillance — or remote analysis — identifies these institutions, while on-site examination confirms the nature and magnitude of the problems.

Notes David Cates of Cates Consulting Analysts: "My firm has been successful in identifying — not with absolute certainty but nevertheless with a high degree of certainty — what institutions are likely to fail in the foreseeable future, and for what reasons. If we can do this, then the regulators ought to be able to do the same — at least as well as we can, if not better."

Presumably, once the risky institution has been identified, the regulators can decide whether its problems will be aggravated or ameliorated by continued access to brokered funds. If the institution suffers from a tendency to misallocate assets, it may be determined that reliance on brokered deposits will only aggravate these difficulties. In that case, the firm can be denied access to the funds.

Blunderbuss Thinking

Regulators have a tendency to propose blunderbuss solutions to problems. "If some institutions misuse brokered deposits, then let's eliminate deposit brokerage," many are implicitly saying. Should the public embrace such a solution? One hopes that it won't.

Killing the institutional market in brokered insured deposits may serve legitimate public-policy objectives. Killing the noninstitutional market does not. Destroying a market — primary and secondary — that has benefited both savers and institutions and may prove of much greater assistance in the future is hardly the appropriate way to handle isolated cases of abuse.

Such abuses can and should be handled on a case-by-case basis. The FDIC-FHLBB proposal for limitation of insurance coverage on brokered deposits should be summarily rejected. ■

Reprinted from
American Banker
The Daily Financial Services Newspaper
February 26, 1985

Comment

Refocusing on Brokered Deposits

By SANFORD ROSE

As a famous legislator once quipped: "Don't blame you! Don't blame me! Blame the man behind the tree!" Today the man behind the tree is the deposit broker, the favorite whipping boy of a goodly number of panicky regulators, bemused congressmen, and credulous journalists. Many would curtail or even ban the brokered deposit, which is said to have contributed to the failure of countless financial institutions.

The palpable falsity of this proposition is demonstrated in a recently released study by Cates Consulting Analysts of New York. The study examines the reasons for failure at the 60 commercial banks and some 16 savings and loans that folded between January 1 and Sept. 30, 1984. Particular attention is paid to the role of brokered deposits in these 76 failures.

Of the 60 commercial banks that failed in the first nine months of last year, 37 (63%) had no brokered deposits whatsoever. Of the 23 that used brokered funds, nine employed them so sparingly that they could not have played any measurable part in the collapse of these institutions. The median ratio of brokered money to total deposits at these banks amounted to less than 7%.

Six failed banks made moderate use of brokered funds — 20% or less of total deposits. Only eight banks — 13% of those that went belly-up during the period — might be described as immoderate gatherers of brokered funds, with usage amounting to more than 20% of total deposits. And only two of these eight banks were brokered-funds hogs, taking more than 37% of their total deposits out of the brokered-funds market.

There were 17 failures of savings and loans from January 1 to September 30 of last year. Data are available on 16 of these unfortunate institutions. Ten of the S&Ls had no brokered deposits at all. Of the six that used brokered funds, two got less than 2% of their total deposits from brokers, one obtained 19% of its money in this form, and in only three cases was the ratio of brokered to total deposits greater than 20%.

Other Money Could Be Had

The most significant datum in the Cates study concerns the ratio of brokered funds to all forms of purchased money. The brokered deposit, whether retail or wholesale, bears some of the characteristics of purchased money. Brokers of retail funds generally aggregate retail deposits and place the funds in institutions in units of $100,000. Those who deal in wholesale funds perform the reverse operation, disaggregating larger chunks of money and also placing them in units of $100,000. Thus nearly all forms of brokered money appear on balance sheets in the category of large liabilities — $100,000-and-over deposits.

As the Cates study points out, brokered funds represent only one category of large liabilities. Jumbo CDs, fed funds, repos, and commercial paper constitute the bulk of other types of purchased money.

Observes Ray Garea, an executive vice president of the Cates group and the author of the study: "If we find that significant levels of brokered deposits were present in a substantial number of 1984 bank failures, that does not necessarily support a conclusion that brokered deposits cause or were even related to such failures. If the banks that failed made excessive use of other types of purchased money, it would be inappropriate to focus on brokered funds alone as a cause of failure. Attempting to limit or eliminate the use of brokered deposits would have little effect if banks could merely shift to other forms of purchased money."

A glance at the Cates data reveals that this is precisely what would happen. Surprisingly, failed banks that used brokered deposits have had abundant access to other bought money. The ratio of brokered deposits to bought money at the 23 failed banks that tapped the brokered-funds market was only 37%. In other words, the users of brokered money were able to obtain 63% of their purchased-money requirements from nonbroker sources — ostensibly from unwary investors in their local markets.

Looked at from another vantage, the 23 failed banks with brokered deposits were excess users of bought money. They funded nearly 40% of earning assets with large liabilities. But only 13% of their assets were funded with the brokered-deposit component of bought money. The rest of the cash came from directly placed paper. Thus the evidence would seem to indicate that, absent brokered funds, these banks could have gone elsewhere to finance their shaky portfolios.

The same point can be made about the six failed S&Ls that made use of brokers. The ratio of brokered deposits to purchased funds at these institutions amounted to 48%. Clearly, thrift users of brokered money were able to obtain more than half of their total requirements from other sources.

Scrap the FHLBs!

Where did these six as well as the other 10 failed thrifts get the purchased money that financed an excessive portion of their earning assets? That's easy. They got a large chunk of it from their respective Federal Home Loan Banks. Purchased funds at the 16 failed thrifts financed around 30% of earning assets. The proportion of earning assets funded by FHLB advances at these institutions averaged nearly 14%.

Failed thrifts made considerably greater use of FHLB money than did healthier associations. The question might then be legitimately asked. If the regulators themselves provided the wherewithal for shaky associations to greatly expand their operations, how is it possible to single out for condemnation the deposit broker, who in some cases merely supplemented the effort of the governmental authorities?

Or as analyst Ray Garea puts it more piquantly: "If one wants to argue that a specific liability category causes S&L failures, then the solution is to dismantle the Federal Home Loan Bank System!"

But the obvious fact is that specific liability categories are not responsible for the demise of thrifts or for that of commercial banks either. The 16 savings and loan casualties of 1984 perished because they assumed even more interest rate risk than did their peers. As a result, their net interest margins and their book capital positions deteriorated more rapidly than was the case at those associations which still cling to life.

The 60 commercial banks that failed in 1984 did so because of problems of asset quality. In 1983, the median ratio of nonperforming loans to total loans at these 60 institutions was an astounding 11.44%. The ratio of chargeoffs to loans in 1983 was approximately 10 times greater in these 60 banks than it was for banks in general. Even in 1982, 40% of the 1984 failures had loan losses equal to or greater than 1.46% of total loans.

Walking Corpses

The conclusion is inescapable: Banks and thrifts fail because of their inability to manage credit risk and/or interest rate risk. The presence of absence of brokered deposits is largely irrelevant to their condition.

Indeed, in most cases, it can be shown that failed banks or thrifts were walking corpses long before they acquired significant amounts of brokered money, if, in fact, they did so. Consider two examples of 1985 failures that have recently been reported. Just this month, the $20 million-deposit Peoples Bank & Trust Co. of Wartburg, Tenn., and the $33 million-deposit West Valley Bank of Woodland Hills, Calif., were closed. Both banks were alleged to have acquired large amounts of brokered deposits to engage in speculative and shady deals — a phenomenon dubbed linked financing. The implication is that these institutions failed because of the relationship between brokered money and questionable or illegal enterprises. But nothing could be further from the truth.

The Tennessee institution posted losses of 3.64% on assets and and had chargeoffs equal to 6.30% of loans in 1983, at a time when its reliance on brokered money had not yet ballooned. Indeed, in that year large liabilities as a percent of earning assets was 21%, actually down from the 32% recorded in 1982.

Given its losses and an alarming drop in its capital ratio, the $20 million bank was experiencing terminal difficulties before it made the decision to acquire an estimated $8 million to $10 million in brokered funds. The decision to seek those funds was undoubtedly a desperate gamble designed to reverse the inevitable greased slide into oblivion.

The Cause Was Gluttony

The bank's real difficulties began when it overlent outrageously in 1980. In that year, commercial loans grew by a vertiginous 51%, and this was followed in 1981 by a further 40% explosion in the commercial loan portfolio.

The West Valley Bank lost 50 basis points on assets in 1983 and 40 basis points the year before. Its return on assets had been slipping since 1980. The bank recorded net chargeoffs equal to 2.17% of loans in 1981. After falling to 1.01% in 1982, chargeoffs climbed back to 1.51% in 1983. By 1982, the bank's other real estate owned as a percent of loans plus OREO had reached 4.52%.

Quite obviously, this institution was drowning in bad real estate loans. In 1980, the growth of nonretail loans amounted to an eye-popping 70%. Apparently, the bank had enormously expanded its commercial real estate portfolio at precisely the wrong time, reaching both for unsustained volume and for yield.

Interestingly, in 1983, West Valley's reliance on large liabilities was no greater than that of regional peer banks in the same size group, although dependence on purchased money had been greater in the past. But no one can reasonably argue that purchased or brokered money undid West Valley. The bank was already in extremis in 1983.

That year, it appears to have suffered a crippling loss of collected demand deposits, as strapped borrowers seemingly could not maintain the level of their compensating balances. Hence, they engaged in a continuous round of check writing, which inflated cash items in the process of collection and sharply reduced the bank's ratio of earning assets to total assets.

At West Valley, more than a third of reported assets did not earn a dime in 1983. Any bank that can't stop the hemorrhaging of investable demand balances is terribly ill. The fact that West Valley subsequently embarked on a madcap insurance scheme funded with brokered money is very nearly beside the point.

Slighted Virtues

Those who blame brokered money for the failure of depository institutions overemphasize the dangers and all but ignore the virtues of the brokerage function. Brokerage improves the efficiency of markets, and if allowed to flourish, may contribute to the ability of banks and thrifts to provide borrowers with long-term credit accommodations. (See "In Praise of Brokered Deposits," the *American Banker*, March 29, 1984.)

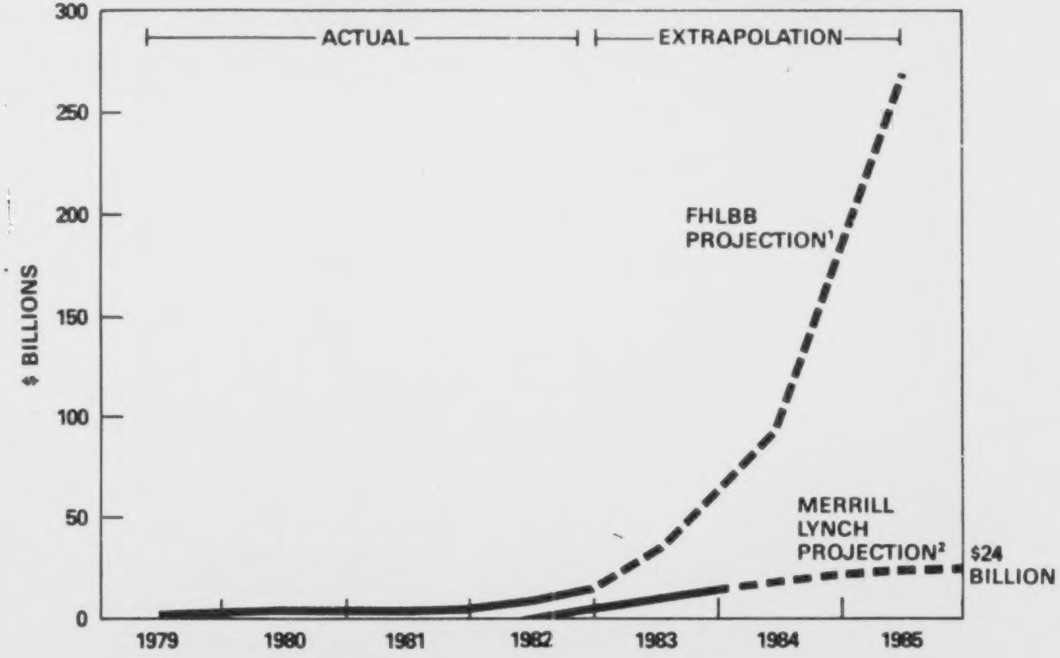
While there are some problems with unrestricted brokerage, these can for the most part be eliminated with minor reforms. It is simply idiotic, however, to link brokerage to the demise of depository institutions. The Cates study is a partisan document, to be sure. It was written for Merrill Lynch. But it is soundly researched, and its conclusion — that there is little, if any, causal connection between brokered funds and bank or thrift collapse — is unassailable. ■

EXHIBIT IV

COMPARISON OF FHLBB AND MERRILL LYNCH

GROWTH PROJECTIONS

BROKER-ORIGINATED DEPOSITS AT FSLIC-INSURED INSTITUTIONS

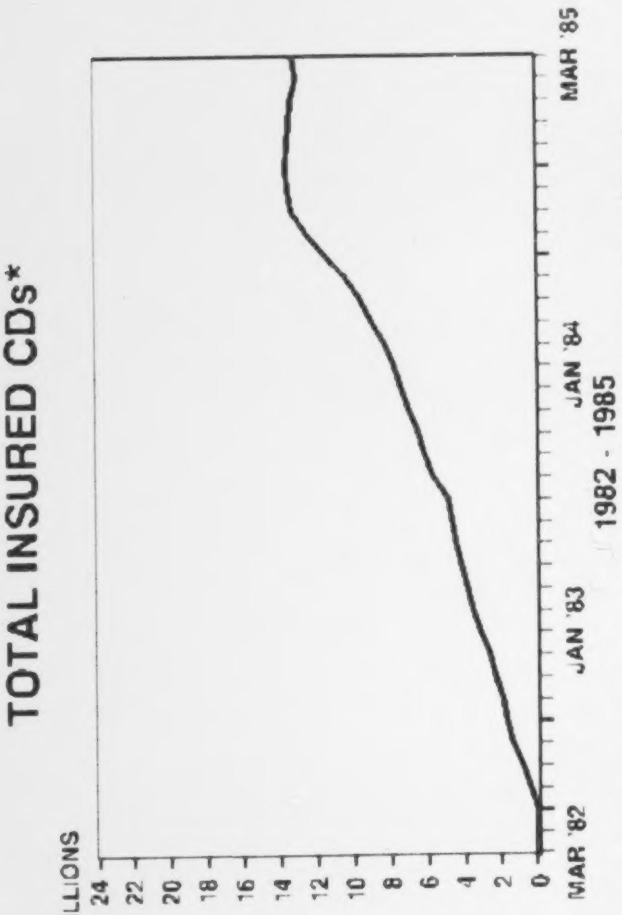


[1] FHLBB ACTUALS AND PROJECTIONS ARE FROM JANUARY 16, 1984 FHLBB NEWS RELEASE. EXTRAPOLATION IS "BASED ON AVERAGE GROWTH RATE SINCE JUNE 1982."

[2] MERRILL LYNCH ESTIMATES AND PROJECTIONS OF INDIVIDUAL INSURED BROKERED DEPOSITS AT THRIFTS REFLECTING THREE STAGES OF DIDC DEREGULATION: MAY 1982 (3½ YEARS AND LONGER), APRIL 1983 (2½ YEARS AND LONGER), OCTOBER 1983 (MOST REMAINING TIME DEPOSITS).

EXHIBIT V

MERRILL LYNCH INSURED CD OUTSTANDINGS



* MERRILL LYNCH INSURED RETAIL CD PROGRAM: $1,000-$90,000 DENOMINATIONS, MATURITIES OF 3 MONTHS TO 12 YEARS, SOLD THROUGH RETAIL ACCOUNT EXECUTIVES LARGELY TO INDIVIDUALS.

EXHIBIT VI

REPRINTS OF BARNARD REPORTS

*SEPTEMBER 28, 1984 "FEDERAL REGULATION OF BROKERED DEPOSITS IN PROBLEM BANKS AND SAVINGS INSTITUTIONS"

APRIL 25, 1985 "NEW FINDINGS ON BROKERED DEPOSITS"

---

*Available from the House Committee on Government Operations (House Report 98-1112)

DOUG BARNARD, JR., GEORGIA, CHAIRMAN
JOHN M. SPRATT, JR., SOUTH CAROLINA
JOE KOLTER, PENNSYLVANIA
BEN ERDREICH, ALABAMA
ALBERT G. BUSTAMANTE, TEXAS

NINETY-NINTH CONGRESS
Congress of the United States
House of Representatives
COMMERCE, CONSUMER, AND MONETARY AFFAIRS
SUBCOMMITTEE
OF THE
COMMITTEE ON GOVERNMENT OPERATIONS
RAYBURN HOUSE OFFICE BUILDING, ROOM B-377
WASHINGTON, DC 20515

LARRY E. CRAIG, IDAHO
PATRICK L. SWINDALL, GEORGIA
H. JAMES SAXTON, NEW JERSEY

MAJORITY—(202) 225-4407

April 25, 1985

MEMORANDUM

TO: Chairman Barnard

FROM: Donald P. Tucker, Chief Economist

SUBJECT: New Findings on Brokered Deposits

In September of last year, the subcommittee issued a report on the subject of brokered deposits entitled, "Federal Regulation of Brokered Deposits in Problem Banks and Savings Institutions" (House Report 98-1112). Because of the possibility that the House will consider H.R. 107 or similar brokered deposits legislation this session, you have directed the subcommittee staff to continue to monitor banking agency data on brokered deposits usage, especially the role of brokered funding in problem and failed banks and thrifts. Major requests for new data and interpretive findings on brokered funding were sent to the three bank regulators on December 19, 1984, and a somewhat different request was sent to the Home Loan Bank Board on January 25. This memorandum summarizes the principal findings and conclusions from these inquiries.

This memorandum also reports briefly on a recent research paper entitled "Brokered Deposits and Bank Soundness: Evidence and Regulatory Implications" released in November by the Federal Reserve Bank of New York.

It is important to note that the most recent data reflected in these agency responses is from the statistical reports to the agencies as of September 30, 1984 (except that the FDIC's listing of individual bank failures, with brokered funds percentages, is complete through April 10, 1985). The December 31 data for individual institutions was not available at the time the requests were made and would probably not have been meaningful anyway, especially for commercial banks. The agencies' rule to restrict the insurance coverage of brokered funds would have been effective for commercial banks as of October 1 if it had been upheld in the Court of Appeals, and the prospect of retroactive enforcement of this rule back to October 1 seriously impacted the brokered funds activities of commercial banks after September 30. For this reason, December data would not have reflected normal brokered funds usage.

Summary of Findings

In summary, the following conclusions can be drawn from this most recent data:

A. Commercial Banks:

1. Among commercial banks, abusive use of brokered funds is generally limited to small institutions, who hold only a tiny fraction of the total brokered funds in banks. There is no evidence of abusive use of brokered funds by the large billion dollar institutions, even though they hold the vast bulk of the brokered funds in banks.

2. The figure of $9+ billion that has frequently been cited by the FDIC as the amount of brokered funds in "troubled" banks (CAMEL-rated 3, 4, or 5) has no meaning or relevance as an indicator of the size of the brokered funds problem. As of September 30, $8 billion of this amount was held by 13 or 14 large national banks whose "troubled" classification had nothing to do with their reliance on brokered funding, according to the Comptroller of the Currency. Most of this $8 billion in brokered funds was uninsured anyway.

3. Brokered funding is declining dramatically as a factor in recent bank failures. Failures of banks having 5 percent or more brokered funding declined from 56 percent of all failures in 1983 to 23 percent of all failures in the last half of 1984. In the first 3 months of 1985 (through April 10), the corresponding percentage was 17 percent (see Table 1).

4. For these reasons, there appears to be no current need for the kind of severely restrictive regulation or legislation on brokered funds that the FDIC proposed in 1984 and has continued to advocate in the current session of Congress.

B. Savings and Loan Associations

5. The brokered funds situation among savings and loan associations is somewhat different than among banks, with more brokered deposits in problem institutions ($11.2 billion) and a substantially greater proportion of the brokered funds among problem institutions (as rated at March 31) being held by small and medium-size institutions under $1 billion in deposits (see Table 2).

6. During the 6-month period from March 31 to September 30, 1984, brokered deposits in problem institutions rated 4 or 5 as of March 31 declined at a 20 percent annualized rate, at the same time that brokered funds in nonproblem institutions were growing at an 84 percent rate (see Table 2). This appears to confirm the earlier judgment of the subcommittee that the regulators can control excessive brokered funding growth by problem institutions through supervisory means alone, without imposing harsh new regulations or legislation.

7. Tabulations requested by the subcommittee show that during this same 6-month period there was substantial noncompliance with the Bank Board's March 26, 1984, interim rule limiting the brokered funds growth of institutions with low net worth (see Table 3). The rule was not effectively enforced. It therefore appears that even better supervisory control over brokered funds usage, at least among institutions with impaired net worth, can be obtained simply through consistent enforcement of the existing rule, without any need for further regulations or legislation.

8. The FHLBB, at the subcommittee's request, reviewed the cases of several large problem institutions experiencing serious asset quality problems, some of which had made heavy use of brokered funding and some of which had not, to determine what difference the use of brokered funding had made. The FHLBB failed to find any fundamental systematic differences between the cases that relied upon brokered funding for their growth and those that did not, except that linked financing arrangements appeared to be present in a couple of the brokered funds cases. The FHLBB, also in response to the subcommittee's specific inquiry, reported no evidence that the institutions using brokered funds paid more for their funding than comparably situated institutions paid for nonbrokered funds.

9. The Bank Board's new net worth requirements, effective March 21, 1985, will seriously limit the ability of institutions to continue the rapid growth policies they have followed in the past with brokered funds. It would be reasonable for Congress to await an assessment of the effect of this new rule before concluding that additional restrictions directly on deposit brokerage are needed.

C. New York Fed Study

10. The New York Fed research study on brokered deposits, although purporting to establish empirically the need for a brokered funds cap, does not provide meaningful evidence to support a need for further brokered funds regulation or legislation.

Commercial Bank Findings

The subcommittee's most recent inquiry to the bank regulatory agencies was designed to establish the significance of the $9+ billion figure that has frequently been cited by the FDIC as the amount of brokered funds in "troubled" banks (CAMEL-rated 3, 4, or 5).

It appeared from the March 31, 1984, data provided earlier to the subcommittee and reported in the Government Operations Committee report[1] that most of this $9+ billion was probably in large institutions having over $1 billion in deposits, but no large banks have ever been cited by the FDIC as examples of brokered funds abuse. Therefore, in order to determine whether the $9+ billion in troubled banks indicated accurately the magnitude of problems caused by insured deposit brokerage, the subcommittee, in letters dated December 19, 1984, requested the three bank regulators to prepare detailed analyses of the brokered funds activities of all large banks (at least $1 billion in domestic deposits) having a CAMEL rating of 3 or worse and having brokered deposits at least 5 percent of total domestic deposits.

---

[1] "Federal Regulation of Brokered Deposits in Problem Banks and Savings Institutions", 52nd report by the Committee on Government Operations, September 28, 1984.

The agencies were asked to report, as of September 30, on the number of institutions meeting these conditions, their total brokered deposits, the percentage of these brokered deposits that were insured, and the average interest rates being paid on brokered funds by these banks. Each agency was also asked to evaluate independently, for the banks under its supervision, whether these banks appeared to be paying abnormally high rates for their brokered funds, and whether the receipt of brokered funding was linked in any of these banks to the particular problem loans or other impaired assets that caused the poor CAMEL ratings.

No state member banks fell into this classification, and hence the Federal Reserve did not provide a substantive response on these questions. Fifteen national and state nonmember banks, holding a total of $8.1 billion in brokered funds, fell within this classification. National banks rated 3 or worse held 98 percent of this amount (almost $8 billion). Hence the response by the Comptroller of the Currency (dated February 8, 1985, and attached to this memorandum) provides the relevant analysis for virtually all these banks.

With regard to the large national banks that accounted for $8 billion out of the $9+ billion of brokered funds in troubled banks, the Comptroller responded that "we can state for the record that there was no evidence of a systemic problem relating to the imprudent deployment of brokered funds." Recent examinations of these banks have found no evidence that brokered funding was being used specifically to fund speculative loans, although such evidence has been found in several smaller institutions.

The Comptroller's Office found from a survey of the banks involved that they were generally not paying premium rates of interest for their brokered funds, and that only about 25 percent of these brokered funds was insured. In response to the subcommittee's final question, regarding whether these banks might have fared better if some rule limiting the insurance coverage for brokered deposits had been in effect earlier, the Comptroller's response was as follows:

> We cannot infer from any evidence, either historical or current, that these large institutions might not have gotten onto the problem bank list and/or [might have] returned more quickly to a sound status if insurance coverage had not been available for

> brokered deposits. In larger institutions, insurance coverage is not considered to be a significant factor in brokered funding.

A small portion ($150 million; less than 2 percent) of the brokered deposits in these large banks was in one or more FDIC-supervised banks. The FDIC response to the same questions from the subcommittee also found no significant rate premium being paid for brokered funding. Approximately 50 percent of the brokered funds in these FDIC-supervised banks was insured. Regarding the connection between brokered funding and problem loans, the FDIC concluded that in one of these banks there appeared to be a connection between extensive brokered funding and problem loans between the 1981 and 1982 examinations. Even the FDIC response, however, does not appear to find strong support for new regulations or legislation on brokered funds from the large-bank cases it examined at the subcommittee's request.

On the basis of these reports from the Comptroller of the Currency and the FDIC covering over $8 billion of the brokered funds in troubled banks, it is clear that the figure of $9+ billion that has frequently been cited by the FDIC as the amount of brokered funds in troubled banks has no meaning or relevance as an indicator of the size of the brokered funds problem. With the possible exception of the one institution referred to in the FDIC response, connections between bank problem status and the use of brokered funding have never been found in banks having $1 billion or more in assets, and yet such large banks account for most of the $9+ billion figure the FDIC continually refers to.

Savings and Loan Association Findings

The subcommittee's recent brokered funds inquiries to the Federal Home Loan Bank Board were designed with three objectives in mind. The first objective was to obtain updated statistical information on brokered funds usage generally from the quarterly reports filed with the Bank Board by all institutions. The second objective was to determine from these same quarterly reports whether the Bank Board has been enforcing its interim rule limiting brokered funds growth by institutions with low net worth. The third objective was to obtain the Bank Board's analysis, based on a study of individual case examples, of what difference it makes whether a problem institution gets into trouble with brokered funds or with nonbrokered funds.

Brokered funds statistics: The tabulations of brokered funds statistics prepared at the subcommittee's request by the Federal Home Loan Bank Board cover the period from March 31 to September 30, 1984. The tabulations previously reported in the committee report had covered the 3-month period ending March 31.

The previous tabulations had provided separate information on the brokered funds usage of problem and nonproblem institutions, by size, according to the supervisory classifications of the institutions on March 31. The new tabulations examine the more recent brokered funds growth of the same problem and nonproblem institutions as were reflected in the earlier tabulations. This was done by basing the separation between problem and nonproblem institutions on the same classification date, March 31.

The new tabulations show that brokered funds growth among the problem institutions as a group completely stopped after March 31. In the first three months of 1984, as reported in Table 1 of the committee report, brokered deposits grew at an annualized rate of more than 100 percent in problem S&L's, but during the next six months the brokered deposits of the same institutions declined at a 20 percent annualized rate (see Table 2 attached to this memo). The ratio of brokered to total deposits in these institutions likewise declined from 6.8 percent to 5.8 percent. These figures have been corrected for any distortions due to mergers or failures and reflect only the brokered funds changes in operating institutions that have not merged.

There were individual exceptions to this general pattern. Out of a total of 678 problem institutions at the end of March, 13 institutions experienced rapid deposit growth in the next six months funded primarily with brokered funds, and the brokered funds growth of these few institutions was extraordinary, as shown in Table 4, attached. It is important to note, however, that this figure of 13 institutions contrasts sharply with the 49 problem institutions that engaged in rapid growth with brokered funds in the first quarter of 1984 (as shown in Table 5 of the committee report on brokered funds).[2]

---

[2] Rapid deposit growth in this analysis is an annualized rate of deposit growth in excess of 25 percent.

This decline in brokered funds among problem institutions between March and September did not reflect any general decline in brokered funding among S&L's. In nonproblem institutions, brokered funds grew at more than an 80 percent annualized rate during this period (see Table 2). Moreover, it does not merely represent the withdrawal of uninsured deposits by cautious brokers; the dollar total of retail-size ($100,000 or less) brokered deposits also declined during this period in the problem institutions.

It is not possible to determine the cause of this decline among problem institutions. It could be voluntary restraint by the institutions themselves, more effective supervision by the FHLBB, increased caution by the brokers about where they place their funds, or some combination of these factors. Whatever the reason, however, this data would appear to indicate that there is a correcting mechanism already at work in the supervisory system or the market place that calls into question the need for any new regulations or legislation on brokered funding for insured institutions.

Compliance with interim rule: The FHLBB issued on March 26, 1984, (and then clarified on April 23) an interim final rule restricting the acquisition of brokered deposits by insured institutions whose net worth was less than 3 percent of liabilities. The rule prohibited any institution whose net worth was less than 3 percent of liabilities and whose brokered funds were more than 5 percent of liabilities from increasing its brokered funds liabilities above the level held on March 26, 1984. In order to assess the degree of compliance with this rule, the subcommittee requested statistical tabulations from the FHLBB showing the brokered funds growth, by quarter, of all institutions whose net worth made them subject to the rule.

Table 3 attached to this memo reports the principal results of these tabulations, except that institutions with less than 10 percent brokered funds are not covered. As shown in this table, 21 of the 122 institutions having low net worth and at least 10 percent brokered funds on April 1 added more brokered funds during the first quarter the rule was in effect, and the average brokered funds increase was very substantial. Then in the next quarter, beginning July 1, 24 of the 113 institutions having low net worth and at least 10 percent brokered funds added more brokered funds, and again the average percentage increase was substantial. These figures represent apparent noncompliance rates of 17 and 21 percent respectively in these two quarters, even ignoring the noncompliance by other institutions whose initial percentage of brokered funds was between 5 and 10 percent.

On March 14 of this year, the subcommittee wrote again to the Bank Board requesting further information on these cases of noncompliance, including information on the enforcement steps taken. No reply has yet been received. Pending receipt of this reply, however, it would appear from these figures that there is room for major improvement in the enforcement of existing Bank Board rules.

Finally, it is important to note that enforcement of regulations of this sort is handled by the principal supervisory agents, who are senior officers of the individual Federal Home Loan Banks, and not by staff of the Bank Board in Washington. The severe budget limitations imposed by OMB on Bank Board staffing, about which Chairman Gray has frequently complained, do not affect the staff responsible for enforcing rules of this sort. The budget limitations do affect the examination staffs, but examination staffs generally do not need to be involved in enforcing this rule because the information on compliance by individual institutions is provided through routine quarterly reports.

Differences due to brokered funding. In order to make some empirical comparison about what difference brokered funding makes, the Bank Board was asked to select 10 or more large problem cases with serious asset quality problems, including at least 5 which had relied heavily on brokered funding and at least 5 others which had made little or no use of brokered funding. The Bank Board's analysis was to describe the asset quality problems of each institution and summarize the supervisory steps taken, provide certain statistics on the growth of brokered and total deposits, evaluate whether the brokered funding used by some of them was more expensive than similarly situated institutions were paying for nonbrokered funds, and evaluate what difference the brokered nature of the funding in some institutions seemed to make.

In response to the subcommittee's question about the cost of brokered funds, the FHLBB reported no direct evidence that the institutions using brokered funds paid more for their funding than similarly situated institutions paid for nonbrokered funds.

To the more important question on how the asset quality problems of the institutions using brokered funds differed from the asset quality problems of the other institutions, the FHLBB response was as follows:

> ...we have concluded that imprudent, reckless growth can occur without brokered funds. However, we have several known incidents of linkage of brokered deposits to questionable loans and the facility of movement of brokered deposits (as opposed to the use of self-organized money desks, advertising or other funds) provide significant oversight and volatility problems.

In effect, therefore, the FHLBB did not find it possible to document, from the case examples selected by the agency, any systematic differences among large problem institutions related to the use of brokered funding, with the possible exception of certain linked financing arrangements.

It is possible that a case can be made that linked financing arrangements, whereby the bank or thrift institution agrees to make certain loans designated by the deposit broker in return for the placement of a certain amount of deposits with the institution by the broker, are generally undesirable and pernicious, and that such practices should be curtailed by regulation or legislation. But any finding that linked financing practices by deposit brokers are undesirable does not justify general restrictions on deposit brokerage. The Bank Board's comparison of large problem institutions therefore provides no support for new restrictions on deposit brokerage generally.

New net worth requirements: Brokered funding has typically been used to fund very rapid growth of loans and other investments by aggressive savings and loan association managements. The Bank Board, in a new rule which was effective on March 21, 1985, has just acted to impose graduated net worth requirements that are higher for rapidly growing institutions than for slow-growing institutions, and the new rule also requires an institution to obtain prior supervisory approval from the principal supervisory agent of its Federal Home Loan Bank before it can sustain a growth rate of more than 25 percent per year. Both elements of this new net worth rule will impose substantial new restrictions on the ability of savings and loan associations to pursue the very rapid growth strategies that have been possible in recent years using brokered funding.

The major impact on brokered funds growth that should be expected from this new rule adds another reason to question the need for additional regulations or legislation directly related to brokered deposits. It would seem appropriate at least to wait until the effect of the new net worth rule and other supervisory steps can be assessed.

New York Fed Study of Brokered Deposits

In November 1984 the Federal Reserve Bank of New York released a research study by Sherrill Shaffer and Catherine Piché entitled "Brokered Deposits and Bank Soundness: Evidence and Regulatory Implications". The principal empirical findings of this study are the following:

1. Cross-section data for 1983 and 1984 show a significant statistical relationship between the percentage of brokered deposits in a bank and financial weakness.

2. Among the 18 insured commercial banks that failed between September 30, 1983, and March 31, 1984, those with relatively more brokered deposits tended to impose a higher relative cost of failure on the FDIC than other banks.

On the basis of these empirical findings, the authors report that "These results suggest a cap on brokered deposits, set in the range of 5 to 10 percent of total deposits, as an effective way of curbing the abuses of brokered deposits while retaining their benefits."

The first empirical finding is very difficult to interpret, and may not support the paper's conclusion, for two reasons. First, the manner in which the authors measure what they call "financial weakness" is subject to serious question. Their "financial weakness" measure for each bank is based on 4 financial ratios of the bank:

(a) loans and leases to total funds;
(b) commercial and industrial loans to total loans;
(c) expenses to revenues; and
(d) total capital to risk assets.

(The first three are taken as indicators of weakness, while the final one is an indicator of strength and is used in the formula with a negative sign.)

Whereas the authors consider the first two ratios to be indicators of weakness, they can also be regarded merely as indicators of aggressive banking practice. High values of these ratios do not per se constitute weakness. The third and fourth factors, on the other hand, are more direct measures of weakness, but they tend to be correlated with each other because of the accounting relationships between revenue, expenses, and capital and therefore do not represent two independent measures of weakness. Any bank with a low capital ratio will inevitably tend to have a high ratio of expenses to revenues.

The other difficulty with the authors' finding about the association between brokered funding and what they call financial weakness is that they do not examine the direction of causation. The weak institutions (assuming you accept their measure of weakness) may merely have a greater tendency to use brokered funds because they are weak, in which case the data do not show that brokered funding caused the weakness. The authors even acknowledge that "certain other weak institutions [that did not fail] may have been able to grow out of trouble or survive temporary hardship by means of brokered funds." This statement would seem to confirm that their results do not necessarily imply that brokered funds caused the weakness of the weak institutions.

As regards the second finding, about the relationship between the use of brokered funding and the costs of failures to the FDIC, this finding rests on a very small sample of 18 failures, which incidentally excludes the very expensive failure of the United American Bank of Knoxville, in which there were no brokered funds.

Finally, the statistical analysis employed in this study is subject to several technical criticisms that seriously impair its reliability. General Accounting Office staff provided extensive assistance to the subcommittee in evaluating the statistical methodology of the study.

For these reasons, the New York Fed research study on brokered deposits does not provide meaningful evidence to support a need for further brokered funds regulation or legislation.

DPT:v

Attachments

Table 1

ROLE OF BROKERED FUNDS IN COMMERCIAL BANK FAILURES
1983-85

	1983 Jan-Dec	1984 Jan-June	1984 July-Dec	1985 Jan-April 10
Bank failures	45	43	35	23
Failures having brokered funds at least 5% of total deposits	25	16	8	4
Failures involving 5% or more brokered funding, as percent of all failures	56%	37%	23%	17%
Average brokered funds percentage among failures having at least 5% brokered funds	26%	40%	13%	23%
Deposits in failed banks ($ thousands)	$3,030,280	$1,711,764	$769,175	$461,926
Deposits in failed banks having 5% or more brokered funding ($ thousands)	$1,900,749	$ 776,503	$367,825*	$122,824
Deposits in failed banks having 5% or more brokered funding, as percent of all deposits in failed institutions	63%	45%	48% (18% excluding Girod Trust)*	27%
Brokered deposits as percent of total deposits in all failed institutions	16%	18%	6%	6%

*Girod Trust Co., San Juan, P.R., had $279 million in deposits when it failed August 16, 1984, of which $37 million (13 percent) was brokered. The FDIC does not cite Girod Trust as an example of brokered funds abuse, however. The brokered funds it held came principally from local corporate sources, following institutional practices peculiar to Puerto Rico, according to FDIC staff. If Girod Trust is excluded from these figures, then only $88.5 million or 18 percent of the deposits of the 34 other banks that failed in this period was in banks having 5 percent of more brokered funding.

SOURCE: Listings of commercial bank failures, including amounts of brokered deposits, compiled by FDIC.

Table 2

BROKERED DEPOSITS IN FSLIC-INSURED INSTITUTIONS

September 30, 1984
(dollar figures in $ millions)

	Institutions Size (total deposits)			
	Small (<$100 mil.)	Medium ($100 mil.-$1 bil.)	Largest (>$1 bil.)	All
Brokered deposits held by				
problem inst.	$1,145	$5,671	4,385	$11,201
nonproblem inst.	1,533	5,298	25,035	31,866
all institutions	2,677	10,969	29,420	43,067
problem inst. as % of all brokered	42.8%	51.7%	14.9%	26.0%
Annualized growth rate of brokered deposits 3/31/84 to 9/30/84				
problem inst.	-20.2%	-25.4%	-13.2%	-20.3%
nonproblem inst.	4.7	70.0	93.7	83.7
all institutions	-6.7	10.5	70.7	46.6
Brokered deposits as % of total deposits				
problem inst.	7.2	6.0	5.4	5.8
nonproblem inst.	2.3	2.3	9.9	5.7
all institutions	3.2	3.3	8.8	5.0

NOTE: Problem institutions, in the tabulation, are those with a supervisory rating of 4 or 5 a March 31, 1984.

SOURCE: Federal Home Loan Bank Board tabulations, prepared at request of Commerce, Consumer, and Monetary Affairs Subcommittee.

Table 3

FHLBB ENFORCEMENT OF RULE LIMITING BROKERED FUNDS GROWTH BY INSTITUTIONS WITH LOW NET WORTH*

	April 1 - June 30, 1984		July 1 - Sept. 30, 1984	
	Brokered Funds Percentage on April 1		Brokered Funds Percentage on July 1	
	10-25%	Greater Than 25%	10-25%	Greater Than 25%
Number of institutions with low net worth and at least 10% brokered funds	59	63	58	55
Number of institutions not in compliance (i.e., low net worth and growing brokered funds)	8	13	11	13
Percentage of noncompliance	14%	21%	19%	24%
Average annualized growth rate of brokered funds in noncomplying institutions	332%	68%	160%	84%
Average annualized growth rate of total deposits in noncomplying institutions	48%	52%	44%	52%
Average net-worth-to-liabilities ratio in noncomplying institutions	1.98%	.62%	-.16%	.47%

* The Federal Home Loan Bank Board adopted on March 26, 1984, an interim final rule (later clarified on April 23) which prohibited any institution whose net worth was less than 3 percent of liabilities and whose brokered funds were more than 5 percent of liabilities from increasing its brokered funds liabilities above the level held on March 26.

SOURCE: Federal Home Loan Bank Board tabulations, prepared at request of Commerce, Consumer, and Monetary Affairs Subcommittee.

Table 4

RAPIDLY GROWING SAVINGS AND LOAN ASSOCIATIONS*

March 31 to September 30, 1984

	Annualized Deposit Growth Rate	Annualized Brokered Funds Growth Rate	Brokered Deposits as Percent of Total Deposits	Retail Brokered Deposits as Percent of all Brokered Deposits	Retail Brokered Deposits as Percent of Total Deposits	Number of Institutions	Number of Institutions with Problem Rating, 9/84	Number of Institutions with Impaired Net Worth, 3/84**
Problem Institutions Relying Principally on Brokered Funds* **								
Small	122.8%	305.4%	52.2%	78.2%	40.8%	5	5	1
Medium Size	88.0	181.6	42.0	29.4	12.3	6	4	1
Largest	38.9	122.2	34.6	59.6	20.6	2	0	1
Problem Institutions Not Relying on Brokered Funds								
Small	73.9	-5.5	16.9	28.8	4.9	52	32	25
Medium Size	55.0	-40.2	12.5	44.4	5.6	57	35	29
Largest	30.1	-54.5	9.7	76.2	7.4	4	2	2
Nonproblem Institutions Relying Principally on Brokered Funds* **								
Small	97.8	394.8	34.9	16.3	5.7	18	2	3
Medium Size	55.8	288.3	29.4	26.8	7.9	14	3	0
Largest	65.7	146.2	38.7	44.9	17.4	5	2	0
Nonproblem Institutions Not Relying on Brokered Funds								
Small	72.2	0.8	6.7	45.8	3.1	244	19	36
Medium Size	54.7	19.0	6.8	57.1	3.9	93	12	26
Largest	35.1	79.1	12.5	48.0	6.0	17	3	4

* Rapidly growing institutions are those whose annualized rate of deposit growth from 3/31/84 to 9/30/84 exceeded 25 percent.

** Impaired net worth is a net worth/liabilities ratio less than 3 percent.

*** Deposit growth was principally from brokered funds if the increase in brokered funds from 3/31/84 to 9/30/84 was more than 50 percent of the increase in total deposits.

SOURCE. Federal Home Loan Bank Board tabulations, prepared at request of Commerce, Consumer, and Monetary Affairs Subcommittee.

RECEIVED
FEB 1[illegible] 1985
COMMERCE, CONSUMER AND
MONETARY AFFAIRS SUBCOMMITTEE

Comptroller of the Currency
Administrator of National Banks

Washington, D.C. 20219

February 8, 1985

Dear Mr. Chairman:

We are pleased to respond to your request dated December 19, 1984 for additional data and interpretive findings regarding the role of brokered deposits in contributing to the problem status of large institutions. In order to respond meaningfully to the Subcommittee's concerns, we utilized the most appropriate resources available to us, including examination reports, discussions with bank and examining personnel, supervisory reporting systems and, in some cases on-site review of bank data. We did not directly contact any brokers since the population included exclusively "problem" banks. Although the market is aware of the problems in most of these institutions, it was felt that inquiries by the regulatory agencies would only serve to foster controversy.

The Subcommittee requested that we respond in terms of a population of banks with the following characteristics: total domestic deposits in excess of $1 billion; brokered deposits in excess of five percent of total domestic deposits; and, a supervisory CAMEL rating of three, four or five. By definition, these banks are large daily takers of funds from a global marketplace. Brokered funds are but one element normally utilized to fund a large bank. Even before any difficulties arose in these banks brokered deposits were used as a regular source of funds depending on rate, maturity, and bank strategy. The banks in this population still utilize brokered funds in much the same manner, that is, as a normal source of funding.

In this population, we could uncover no example where brokered funds contributed to or exacerbated the problems that led to the eventual downgrading of a bank's ratings. In fact, some of the banks' liquidity problems were eased by the prudent and judicial use of brokered funds. In cases where severe problems were evident to the market, access to brokered deposits was severely curtailed. Our findings do not mean to suggest that every bank in every case has developed a prudent strategy to deploy brokered funds. However, for the population of banks defined by the Subcommittee and used in this response, we can state for the record that there was no evidence of a systemic problem relating to the imprudent deployment of brokered funds.

The OCC is concerned about the broader issue resulting from banks' access to a much larger funding base than in the past, including global and domestic markets. While this permits a prudent bank to broaden its funding base and, therefore, theoretically expand its liquidity, occasion may arise where a bank utilizes brokered funds to expand an already weak loan portfolio. Our examination process pays close attention to those institutions that derive a material amount of deposit support from brokered deposits. The examination policy for brokered deposits requires a detailed analysis of the following:

- The volume and extent of reliance upon brokered deposits for liquidity;
- The extent and reasonableness of written policies;
- The bank's ability to repay or replace brokered deposits with other sources of funds;
- Abuse in the acquisition or employment of brokered funds.

It is not in the best interests of the banking system to eliminate brokered deposits as a viable source of funds. The regulatory agencies can, however, mitigate the risk by constant monitoring and effective supervision. We can, have and will continue to take enforcement action against any institutions where brokered funds are a problem or may exacerbate existing problems.

I trust our response has assisted the Subcommittee in dealing with the issue of brokered funds. As an appendix we have responded to the specific and thoughtful questions raised in your letter.

Very truly yours,

C. Todd Conover

C. Todd Conover
Comptroller of the Currency

The Honorable Doug Barnard, Jr.
Chairman
Commerce, Consumer, and Monetary Affairs Subcommittee
Committee on Government Operations
U. S. House of Representatives
Washington, D.C. 20515

APPENDIX

1. Number of institutions in this class.

Fifteen

2. Total brokered deposits and retail brokered deposits as reported in the call reports for September 30, 1984.

Total Brokered Deposits - $8,120,945,000
Total Retail Brokered Deposits - $2,060,862,000

3. Total brokered deposits held by these institutions on September 30 and December 31, 1983 and March 30 and June 30, 1984.

June 1984 - $8,212,301,000
March 1984 - $6,829,010,000
December 1983 - $7,381,397,000
September 1983 - $6,178,611,000

4. & 5.

Estimated amount and ratio of fully insured brokered deposits on September 30, 1984. (also state source for this information).

The total amount of insurance coverage for brokered deposits on September 30, 1984 cannot be accurately determined. Internal records at most of these institutions are not sufficiently detailed to provide the necessary information. However, discussion with bank management revealed that these institutions reported retail brokered deposits to the best of their ability in accordance with call report instructions. The amount of fully insured brokered deposits on September 30, 1984 can reasonably be estimated at approximately $2.1 billion or 25% of total brokered deposits.

6. Estimated median, first quartile measure and third quartile measure of interest rates paid on brokered deposits placed with these institutions during the month of September.

The estimated median, first quartile measure, and third quartile measure of interest rates paid on brokered deposits placed with these institutions during the month of September cannot be reasonably and accurately ascertained. Internal records at these institutions do not adequately segregate rates paid on brokered deposits from other funding rates. However, discussion with examining and bank personnel revealed a range of 10.2 to 11.5%. This range is comparable with rates paid on other instruments.

7. Approximate percentages of the total and insured brokered deposits reported in responses to questions two and four that were held by national banks, state member banks and state non-member banks respectively.

Of the $8,121 million in brokered deposits held by these institutions, $7,979 million or 98.3% are held by national banks with the remaining $142 million or 1.7% held by state non-member banks. The estimated amounts of fully insured brokered deposits is $2.1 billion as of September 30, 1984. The national institutions represent 96.4% of the total with state non-member banks representing 3.6%.

8. Do these institutions appear to have paid more for the funding they obtained from brokers (considering both the rate of interest paid and relevant acquisition costs) than representative and sound institutions of comparable size were paying for nonbrokered funding of similar denomination and maturity at that time? What estimate would you place on the cost differential for the institutions using brokered funds, and what is the basis for this estimate?

Market forces largely dictate that financially troubled institutions pay higher rates for their funding than financially sound ones. It is the general perception that this holds true for brokered funding as well as non-brokered funding, especially in the wholesale marketplace where the financial condition of the institution has been disclosed. It should also be pointed out that when these funds are procured in large denominations the total cost is minimized as processing/acquisition costs are tremendously reduced.

The majority of the institutions indicated that the cost of these brokered deposits were cheaper or no more expensive than non-brokered deposits. Our review revealed that none of the institutions covered by your request has been offering or paying premium interest rates to purchase these deposits. Moreover, there is no direct evidence that these institutions could not have obtained comparable funding on similar terms from non-brokered sources. Other sources of funding were available, but, it was easier and more practical to use the brokered funds market in order to obtain the rates and maturity structure needed.

9. Is there any direct evidence that these institutions could not have obtained comparable funding on similar terms from nonbrokered sources? If any of these institutions might have had funding difficulty in the nonbrokered markets, does this appear to have been an isolated phenomenon affecting one or two institutions only or does it appear to have been a problem for most or all of the institutions concerned? What is the basis for this finding?

   There is no evidence to suggest that these institutions could not have obtained comparable funding on similar terms. Banks in the population use brokered deposits to lengthen the maturity of their liability structure. Brokered deposits are usually of a longer term than most other funding instruments except local deposits. Rate considerations are only one factor a bank considers when deciding on the appropriate mix of liability instruments. In a falling interest rate environment most banks are reluctant to "lock in" interest rates and will rely more on the overnight market to fund assets. In a rising rate environment banks will want to "lock in" interest rates and issue more term instruments, including brokered deposits. Except for the extreme cases where funding is not available at any maturity at any price it is difficult to determine with any precision whether a bank is paying over market for funds since the many different funding instruments differ in rate. We found no case where a bank in the population was paying significantly more for brokered funds merely because alternative funds were not available.

10. Is there any direct evidence in any of these banks linking the receipt of insured brokered funding to the particular loans or other assets whose present impaired status has caused these banks to be classified as "troubled" or "problem" institutions? In other words, were insured brokered funds used directly for the problem loans now on these banks' books? Please report in detail the evidence for any such findings.

   According to OCC monitoring systems/reports which have been implemented nationally, tied lending and the use of brokered deposits to fund speculative/problem loans do not appear to be a problem in the larger institutions. September 1984 information revealed that several smaller institutions had used brokered deposits to fund and/or support speculative loan portfolios (i.e., oil and gas credits and real estate construction loans); but none of the institutions covered by the Subcommittee's request was determined to be using brokered funds directly to support the problem loans on its books.

11. To what extent have any of these institutions engaged in tied lending (i.e., lending to parties designated by a broker, as a quid pro quo for the placement of funds with the bank) in connection with their brokered funding? Where tied lending has been present, have the loans made pursuant to these tying agreements contributed to the banks' troubled or problem status?

    Brokered funds in this population of banks were primarily derived from major nationwide brokers. There was no evidence of any tied lending arrangements.

12. To what extent have these banks continued to solicit insured brokered funds, and to what extent have the major retail stock brokerage firms continued to place new insured funds in these banks, after they were placed on the "troubled" or "problem" lists?

    Banks in the population have continued to solicit brokered funds if available albeit a generally reduced amount. In those institutions where the deposits were used to fund certain loan portfolios the average maturity ranged from twelve to fourteen months. In other instances matched funding was initiated and the maturities were relatively short-term. Discussions with OCC personnel responsible for supervising and monitoring these institutions revealed that several of these banks are curtailing their use of brokered deposits and are making concerted efforts to generate funding from local markets.

13. To what extent can we infer from these findings that these particular large banks (a) might not have gotten onto the "troubled" or "problem" bank lists, or (b) might have returned more quickly to a sound status, if insurance coverage had not been available for brokered deposits?

    We cannot infer from any evidence, either historical or current, that these large institutions might not have gotten onto the problem bank list and/or returned more quickly to a sound status if insurance coverage had not been available for brokered deposits. In larger institutions, insurance coverage is not considered to be a significant factor in brokered funding.

CATES
CONSULTING ANALYSTS
The Authority in Bank Performance Analysis

EXHIBIT VII

CATES CONSULTING ANALYSTS, INC.

"ANALYSIS OF 1984 COMMERCIAL BANK

AND SAVINGS & LOANS FAILURES"

ANALYSIS OF 1984 COMMERCIAL BANK AND SAVINGS & LOANS FAILURES

Prepared by:
Cates Consulting Analysts, Inc.
New York, New York
January 28, 1985

Copyright © 1985 by Cates Consulting Analysts, Inc.

ANALYSIS OF 1984 COMMERCIAL BANK AND SAVINGS AND LOAN FAILURES

TABLE OF CONTENTS

EXECUTIVE SUMMARY 1

I. Introduction 3

II. Failure of Commercial Banks in 1984 5

Methodology 5

Findings 6

Relationship between Brokered Deposits and Failure of Banks in 1984 8

III. Failure of Savings and Loan Associations in 1984 11

Failure of S&Ls in 1981-1984: Overview 11

Analysis of Individual S&Ls That Failed in 1984 11

Methodology 11

Findings 12

Relationship between Brokered Deposits and Failure of S&Ls in 1984 14

IV. Supporting Statistical Tables and Attachment 1 17

ANALYSIS OF 1984 COMMERCIAL BANK AND SAVINGS AND LOAN FAILURES

EXECUTIVE SUMMARY

Our purpose herein is to analyze the failures of both commercial banks and savings and loans in 1984 in order to identify the reasons for such failures. We will also explore the relationship, if any, between brokered deposits and the failure of financial institutions.

We analyzed five critical risk categories in order to determine whether they contributed significantly to commercial bank and savings and loan failures in 1984: liquidity risk, asset quality risk, interest-rate risk, overhead risk, and capital risk. We used selected financial ratios as indicators of the extent to which each of the five risks was present in failed institutions.

Commercial Banks. The evidence clearly shows that asset quality risk was responsible for bank failures in 1984. There were several critical indicators of extremely poor asset quality that were present in most failed banks to a much greater extent than in other banks: high and increasing net charge-offs; levels of non-performing loans serveral times peer group norms; and a loan yield substantially higher than that of other banks, which invariably points to higher risk levels in the loan portfolio. While other risk factors were present to varying degrees in banks that failed, none were nearly as predominant as the characteristics pointing to poor asset quality.

We also assessed whether brokered deposits were a significant factor in 1984 commercial bank failures. Approximately 63% of the 60 banks examined had no brokered deposits and in nine others such deposits comprised less than 7% of total deposits. The number of failed banks with a significant amount of brokered deposits, approximately 23%, was not sufficient to support the contention that brokered deposits caused bank failures. The relatively high dependence on purchased money of banks that failed in 1984, compared with that of similar sized banks, indicates that to focus on brokered deposits is misleading and incorrect. Brokered deposits is only one type of purchased money, and since banks that failed used alternative sources extensively, the reduction or elimination of brokered deposits would have little or no effect on bank failures. Finally, even in failed banks that made substantial use of brokered deposits, the usage of other sources of purchased funds was very high, and on average, accounted for over 60% of total purchased funding in those banks. We conclude that there is little, if any, evidence to support a causal relationship between brokered deposits and bank failures.

Savings and Loans. The data clearly show that an outsize degree of interest-rate risk was the cause of savings and loan failures during the 1981-1984 period. The net interest margin, the key barometer of interest-rate risk for savings and loans, worsened steadily through 1982 for all savings and loans. In failed S&Ls, the margin was considerably lower and the downward trend was more pronounced, suggesting that their risk exposure to adverse rate movements was even higher. The other risk factors were not present in failed savings and loans to a significant extent.

We also examined specifically the relationship between brokered deposits and 1984 savings and loans failures. Brokered deposits were either not present or only present in insignificant amounts in the predominant majority (75%) of 1984 S&Ls. The data also indicate that failed S&Ls used purchased money to a far greater extent than other comparably sized savings and loans.

Consequently, they had access to funding sources other than brokered deposits. The presence of large amounts of brokered deposits in a few institutions reflected management's choice to use brokered funds. It did not indicate a lack of alternative funding sources.

We also examined the extent to which failed savings and loans used Federal Home Loan Bank (FHLB) Advances. For failed S&Ls, FHLB Advances represented, on average, a surprisingly high 68% of total purchased funding and was present in amounts five times greater than in healthy savings and loans. If one were to argue that a specific type of liability causes savings and loan failures, and we certainly do not, the overwhelming evidence points to deposits provided by the FHLB System itself, not brokered deposits. In summary, the data clearly indicate that brokered deposits was not a significant factor in 1984 savings and loan failures.

I. Introduction

The number of financial institutions that have failed in recent years has reached a level that we have not experienced since the Depression in the early 1930s. Savings and loan failures have declined substantially in 1984, following the 1983 decline in interest rates and their continued moderation in 1984. The number of bank failures, however, continued its climb upward, reaching 79 failures for all of 1984.

Our purpose herein is to analyze the failures of both commercial banks and savings and loans in 1984 in order to identify those risk factors that caused such failures. We will of course examine banks and savings and loans separately. Finally, we will study those institutions that failed through September 30, 1984.

It is important to recognize that financial institutions are complex businesses, and therefore, no single reason will likely explain the failure of all of them. Indeed, an in-depth analysis is the only way to determine, with confidence, why a specific institution failed. Nonetheless, we can learn a great deal about the causes of financial institutions' failures by identifying those risks that are present to a much greater extent in most failed institutions than they are in all financial institutions. That is our objective here.

Additionally, we will explore the relationship, if any, between brokered deposits and financial institutions' failures. More specifically, we will assess whether the data support the contention that brokered deposits were a significant factor in the failures of either commercial banks or savings and loans in 1984.

II. Failure of Commercial Banks in 1984

Analysis of Individual Banks that Failed in 1984

Before presenting our findings, we will briefly outline the approach we followed to analyze 1984 bank failures.

Methodology. In performing our analysis, we made substantial use of peer groups, that is, groups of banks that have roughly the same amount of total assets. For all ratios selected, we used the median value for banks in the peer group as representation of typical performance for banks of that size. Additionally, in assessing certain risk factors, e.g., asset quality risk, we compared certain performance measures against norms that we and others who analyze banks have concluded represent high risk.

Our purpose herein is risk analysis: What risk factors were a primary cause of 1984 commercial bank failures? In identifying such indicators of risk, we must assess both their magnitude and the extent to which they are present in all failed banks. This notwithstanding, it is important to review the overall profitability of failed banks in years prior to failure. We examined the profitability of these banks in order to determine whether failure was the product of a steady erosion of capital through operating losses or caused by problems that seemed to materialize quickly with little warning.

We then analyzed five critical risks that commercial banks face in order to determine whether each was present sufficiently in banks that failed in 1984 to have contributed significantly to their failure. The five risks are as follows: liquidity risk, asset quality risk, interest-rate risk, overhead risk and capital risk.

In performing this analysis, we used numerous financial ratios as indicators of the extent to which each of the five risks was present in failed commercial banks. Below is a list of the ratios we included:

Overall Profitability	Return on Assests Net Interest Margin
Liquidity Risk	Large Liabilities to Earning Assets Large Liability Dependence
Asset Quality Risk	Net Charge-Offs to Loans OREO to Loans plus OREO Nonperforming Loans to Loans Loan Growth (including Nonretail Loan Growth) Loan Yield
Interest Rate Risk	Net Interest Margin Shift
Overhead Risk	Overhead to Adjusted Operating Income Overhead Growth Compared with Earning Asset Growth OREO to Loans plus OREO
Capital Risk	Equity Assets Primary Capital to Assets

Findings. The critical risk factor responsible for bank failures in 1984 was asset quality risk. Many of the indicators of poor asset quality - and therefore high risk - were present in most failed banks to a degree far greater than in comparably sized banks. A few examples are as follows: net charge-offs were extremely high and increasing, the amounts of non-performing loans were at levels one could only characterize as absurd, and loan yield was substantially higher than that of other banks.

While the other risk factors were present to varying degrees in banks that failed, none were as predominant as the indicators pointing to poor asset quality. Relative to comparably sized banks, the degree of liquidity risk was certainly higher for banks that failed in 1984, but for most of the failed banks, it was not high enough to be of significant concern. Finally, the low degree of capital risk was noteworthy. As of year-end 1983, only months before failure, almost half of the banks that failed exceeded the proposed regulatory guidelines for primary capital. As of year-end 1982, almost 80% of these banks exceeded the guidelines, while 60% of the banks exceeded them by 90 basis points or more. In short, prior to failure, a lack of capital was not a critical risk for banks that failed in 1984.

For 1984 bank failures, we present below a more detailed analysis of overall profitability and the five risk factors.

1. **Overall Profitability.** In the year before failure, profitability for banks that failed in 1984 was very poor. Only somewhat more than 10% of such banks had a positive return on assets, with about 75% losing more than 1.00% on assets. In 1982, however, the picture was significantly different. While profitability in these banks was substantially below peer norms, unlike S&Ls, there were not widespread losses. Over 65% of the banks that failed in 1984 reported a profit in 1982 and 40% of them achieved a return on assets of 0.66% or higher. In other words, most of these institutions went from profitability (some low and some high) in 1982 to substantial losses in 1983 and failure a few months later.

The primary determinant of earnings performance for a bank is the net interest margin, that is, the net interest spread a bank achieves in funding its earning assets. In most cases, if a bank experiences earnings problems, the net interest margin plays a crucial role. Prior to 1983, a margin shortfall was not a common characteristic of failed banks, and as we will see, the 1983 decline was entirely due to the earnings impact of problem credits.

In 1982, over 60% of the banks that failed in 1984 had a net interest margin above peer norms. Even in 1983, when on average the margin in these failed banks was 75 basis points below peer, it was still 4.70%. This stands in stark contrast to the negative and extremely low net interest margins in S&Ls that failed. It is clear that the behavior of the margin was not a critical factor in bank failures.

2. **Asset Quality Risk.** In assessing asset quality risk, we examined five financial ratios and compared the results for banks that failed with norms for comparably sized banks. The outcome of this process was clear and the conclusion was obvious: asset quality risk was a critical factor in the failure of banks in 1984. In all likelihood, it was the only factor responsible for the failure of most, if not all, of these institutions.

The level of net charge-offs to loans in 1983 was approximately 10 times greater in failed banks than that in other banks. Loan losses were also high in 1982, although substantially below the 1983 level. For 80% of the failed banks, loan losses were 1.34% of loans or higher. Even in 1982, 40% of these banks had loan losses equal or greater than 1.46% of total loans. Obviously, asset quality was poor for banks that failed in 1984.

Loan growth was also present to a significant extent in failed banks. The data do not support a conclusion that loan growth caused 1984 bank failures, as many banks did not experience excessive growth. One interesting occurrence is the dramatic slowdown of growth in 1983, which undoubtedly reflects the obvious appearance of severe asset quality problems to even the managements of the failed banks.

Loan growth, especially nonretail loan growth, was, however, a significant cause of failure in a substantial minority of banks that failed in 1984. For example, the average annual growth rate in nonretail lending for 1980, 1981 and 1982 was, on average, a fairly high 20% for these banks. Approximately 40% of these banks had average growth of 25% or more for this period, a level we consider excessive.

High loan yield in a bank, relative to that in other banks, generally indicates higher levels of risk present in the bank's lending portfolio. By high we do not mean 25 or 50 basis points, but more on the order of 125 basis points or more. The data clearly indicate that failed banks had inordinately high loan yields, and consequently, had substantially greater asset quality risk than other banks. In 1983, the loan yield for banks that failed in 1984 was equal to peer norms, a startling result given their huge levels of nonperforming loans. In other words, the yield on loans was actually considerably higher, but so many of them did not accrue interest that the reported yield is depressed.

In 1981 and 1982, the median loan yield at these failed banks was 139 basis points and 175 basis points, respectively, above peer norms. Additionally, in 1982, 30% of these failed banks had a loan yield 200 basis points over peer, while in 1981 the proportion was over 40%. The message is clear: the level of risk taken by failed banks was considerably higher than that taken by other banks of similar size.

While the evidence regarding asset quality risk in failed banks is strong, the data for nonperforming loans will remove any doubts from even the most closed-minded individuals. In 1983, the median ratio of nonperforming loans to loans for banks that failed in 1984 was an astronomical 11.44%. The level of nonperforming was greater than 6.00% for 80% of these banks. In short, poor quality credits made up a disproportionally high percent of loans at failed banks. The dizzying level of nonperforming indicates how critical the asset quality position in these institutions had become at the end of 1983.

3. **Liquidity Risk.** The critical determinant of liquidity risk is the degree to which a bank is dependent on purchased funds, that is, bought money. The larger the proportion of such funding, the higher the possibility of a bank experiencing liquidity problems and the greater its liquidity risk. In analyzing the data on 1984 bank failures, we found that such banks, relative to others, were much more heavily dependent on purchased funding sources. Most banks that failed, however, were small institutions, which generally make very little use of such funds. Indeed, small banks are usually net sellers of funds to the market place. On average, banks that failed supported 18% of their earning assets with purchased funds, which is not a dangerous level. Approximately 25% of such banks supported more than 30% of earning assets with purchased money. While the data show that liquidity risk was certainly higher for failed banks when compared with other banks of similar size, the level of purchased funding used by such banks does not indicate that liquidity risk was a critical factor in 1984 bank failures.

4. **Overhead Risk.** We examined several financial measures in order to assess the role of overhead risk in 1984 bank failures: (1) overhead as a percent of income, (2) overhead growth, (3) overhead growth relative to earning asset growth, and (4) the magnitude of foreclosed property (OREO), which typically results in substantial increases in overhead expense. The average level of

overhead in failed banks was a high proportion of income, approximately 77% in 1982 and some 20 percentage points above peer norms. In short, overhead could well have been a significant contributing factor.

The level of overhead growth in failed banks was not inordinately high as, on average, it was 15% for the four-year period preceding failure, with a substantial slowing in 1983. An additional 20% of these banks grew overhead between 15% and 20%. More important, the relationship between overhead growth and earning asset growth was a good one, as banks that failed grew assets, on average, 40% faster than overhead expense. This suggests that the poor relationship between overhead and income was a function of the escalating drag of nonperforming loans on the loan yield.

Finally, we examined the levels of foreclosed property (OREO) in failed banks. On balance, the level of OREO was considerably higher in failed banks. The average level of OREO was 1.26% of total loans plus OREO, which was over 100 basis points over peer norms. For approximately 60% of the failed banks, the level of OREO was 0.80% or higher, which was four times greater than the average level in comparably sized banks. The amounts of OREO were therefore significant and likely increased overhead expense by a significant amount.

We conclude that overhead risk itself was not a problem for failed banks and that the higher levels of non-interest expense are the result of asset quality problems.

5. **Interest-Rate Risk.** Because of the severe asset quality problems that failed banks experienced, we cannot use the behavior of the net interest margin to judge the magnitude of interest-rate risk in such banks. We therefore rely on the knowledge that banks, unlike S&Ls, are not subject to an inherent mismatch and therefore are very unlikely to fail because of interest-rate risk. Additionally, the net interest margin for failed banks, on average, was strong in 1982. Further, while the margin for those banks fell substantially in 1983, the reasons were related to asset quality problems. Finally, the median level of the margin remained at approximately 4.70%. The above does not suggest that interest-rate risk was a factor that caused banks to fail in 1984.

6. **Capital Risk.** The data clearly show that capital was not a critical risk that caused 1984 bank failures. While substantially below peer norms, the median level of equity as a percent of assets in 1983 for failed banks was 5.91%. In 1982 it was 6.90%, which hardly suggests serious capital problems.

The median level of primary capital to assets in 1983 was 5.65%, which while below proposed regulatory guidelines is not dangerously low. More important, the median level in 1982 was 7.36% and 70% of the failed banks exceeded the proposed guidelines by 35 basis points or more. In other words, in the years prior to the onset of high loan losses, capital levels in failed banks were well above acceptable guidelines. Clearly, capital risk was not a significant factor in failure.

Relationship between Brokered Deposits and Failures of Banks in 1984

In this section we assess whether or not brokered deposits were a significant factor in the failure of Commercial banks in 1984. In doing so, we also examine the extent to which such banks were dependent on purchased funding sources in total and what proportion of such funding consisted of brokered deposits. By purchased funding we mean large denomination, interest-sensitive money that is at or above the FDIC insurance limit and at risk. Brokered deposits are merely one type of purchased money.

If we find that significant levels of brokered deposits were present in a substantial number of 1984 bank failures, that does not necessarily support a conclusion that brokered deposits caused or even were related to such failures. For example, if banks that failed made excessive use of other types of purchased money, it would be inappropriate to focus on brokered funds alone as a cause of failure.

Additionally, if that were the case, attempting to limit or eliminate the use of brokered deposits would have little effect, as banks would merely shift to other forms of purchased money. In order to reach any valid conclusion about the relationship between brokered deposits and 1984 bank failures, it is therefore critical to examine the use of total purchased funding sources by banks that failed.

1. **Incidence of Brokered Deposits.** The data in Table 1 do not support the contention that, in general, brokered deposits cause bank failures. Of the 60 banks that failed in 1984 through September 30, 37 or 62.7% had no brokered deposits whatsoever. In nine others the level of brokered funds was less than 7% of total deposits, a low and obviously insignificant amount. Therefore, in almost 77% of the banks that failed during 1984, the level of brokered deposits was either very low or nonexistent.

Let us now assess brokered deposit levels for only those failed banks that used such deposits, which total 23. For nine of these banks (almost 40% of those with brokered deposits) the level of brokered deposits was less than 7% of total deposits. In only eight banks, or approximately 13% of those that failed in 1984, did brokered funds exceed 20% of total deposits. Finally, brokered funds exceeded 37% of total deposits in only two banks. Even when looking only at failed banks that had brokered deposits, the levels present are not sufficient to support the argument that brokered deposits cause bank failures.

2. **Level of Purchased Money.** The data in Tables 2 and 3 indicate clearly that failed banks were much more heavily dependent on purchased funding than other comparably sized banks - on balance, 3.4 times more dependent. That relationship held for all size levels. Banks that failed clearly had numerous funding sources available to them. To focus on brokered deposits, which is only one such source, is incorrect and misleading. Additionally, restricting or eliminating brokered funds would not reduce the number of bank failures, as banks would merely shift to other funding sources.

Let us now examine the data only for those failed institutions that had brokered deposits. Here the use of purchased money was approximately four times greater than that of comparably sized banks. In short, the degree of purchased funding obtained from other sources was just as high for failed banks as for banks that had no brokered deposits.

3. **Brokered Deposits to Total Purchased Funds.** Since the median level of brokered deposits in banks that failed was zero, it is only necessary to examine the relationship between brokered deposits and purchased funds for failed banks that had brokered deposits. The data permit some interesting conclusions.

The data in Table 3 indicate that even banks that use brokered deposits, on average, rely on other sources to provide most of their purchased money. For the median bank, brokered deposits accounted for only 36.6% of its total purchased funding. From Table 5 we can see that only slightly more than 25% of this group of failed banks (those with brokered deposits) obtained more than half of their purchased money from brokered deposits.

In summary, we conclude that the number of banks with a significant amount of brokered deposits that failed in 1984, approximately 23%, was not sufficient to support the argument that brokered deposits cause bank failures. The extremely high dependence on purchased money of banks that failed in 1984, relative to that of comparably sized banks, indicates that to focus on brokered deposits is a serious misjudgement. Brokered deposits is only one source of purchased money and its reduction or elimination would have little or no effect on bank failures. Finally, even in failed banks that made substantial use of brokered deposits, the usage of other sources of purchased funds was very high and accounted for over 60% of total purchased funding in those banks. In short, any relationship between brokered deposits and bank failures is highly questionable.

III. Failure of Savings and Loan Associations in 1984

Failure of S&Ls in 1981-1984: Overview

Before examining individual S&Ls that failed during recent years, a brief overview of S&L failures would be useful background. The table below lists the number of failures in each year.

	1984	1983	1982	1981	1980
# of Failures	16*	52	72	28	12

*Number of failures through September 30.

1. Industry pressures resulted in a record number of FSLIC assisted consolidations and liquidations of S&Ls in 1982, a level approximately two and one-half times the number of failures in 1981. Closings continued at a high but lower level in 1983 and declined markedly in 1984.

2. The number of failures during these years was directly related to the sharp downward movement of the net interest margin, with a year lag in actual occurrence. As the margin declined sharply in 1981 and 1982, the number of failures increased in the next two years. The reverse also holds true: as the margin improved in 1983, the number of failures declined significantly in 1984.

3. While the yield and maturity structure of mortgage portfolios contributed significantly to the earnings problems that thrifts experienced, the quality of these assets was sound and did not play a significant role in S&L failures. Historically, scheduled items, the only measure of non-performing loans for S&Ls, have generally remained below 1% of assets.

4. Though Congress gave S&Ls broader asset powers through the passage of the Depository Institutions Deregulation and Monetary Control Act of 1980, the bulk of the thrift industry's earning assets still remained in fixed-rate mortgage loans. Thus asset yields were relatively insensitive to market interest rates throughout the 1981 through 1984 period.

Analysis of Individual S&Ls that Failed in 1984

In our overview of S&L failures in the 1981-1984 period, we concluded that the critical factor affecting earnings performance was the net interest margin. While our experience certainly suggests that the most critical risk historically that S&Ls faced was interest-rate risk, the data indicate that indeed interest-rate risk was the primary reason for such failures.

Interest-rate risk does not, however, cause the failure of a financial institution quickly. Therefore, even though our primary objective is to assess 1984 S&L failures, it is necessary to do so along with failures in the 1981-1983 period.

Methodology. Before presenting our findings, we will briefly, discuss our methodology. In analyzing S&L failures during this period, we frequently compared performance to peer groups comprised of similarly sized S&Ls, always using medians. Additionally, in assessing certain risk factors, e.g., overhead risk, we examined the relationship between two performance ratios for the S&L intself. We first examined overall profitability of these institutions in prior years in order to assess whether failure was the product of a steady earnings drain or whether these institutions were blind-sided by problems that strike quickly, for example, severe loan losses. Next, we analyzed the five primary risks that are present in financial institutions in order to determine whether each was a significant causal factor for S&L failures in the 1981-1984 period: interest-rate risk, liquidity risk, asset quality risk, overhead risk, and capital risk.

In undertaking our analysis, we used selected financial ratios as indicators of the extent to which each of the five risks were present in failed savings and loans. The table below indicates the ratios used.

Overall Profitability	Return on Assets Net Interest Margin
Interest-rate Risk	Net Interest Margin Shift
Liquidity Risk	Large Liabilities to Earning Assets
Overhead Risk	Overhead Growth compared with Earning Asset Growth
Asset Quality Risk	Loan Growth Other Mortgage Loans to Loans OREO to Loans plus OREO Loan Yield
Capital Risk	Net Worth to Assets

Findings. Our conclusions for each of the years examined - 1981, 1982, 1983, and 1984 - are the same. We therefore will present and discuss all four years together, noting any exceptions.

The primary determinant of earnings performance for a financial institution is the net interest margin, accounting for 70% to 90% of the earnings stream for commercial banks and an even higher percentage for savings and loans. Consequently, the impact of an adverse trend in the margin far outweighs the effects of other performance indicators. In short, that is what occurred for S&Ls that failed during the period examined.

The critical risk factor responsible for S&L failures during the 1981-1984 period was interest-rate risk. The level and the trend of the net interest margin were considerably worse in failed S&Ls as compared with that of appropriate peer groups. While all other risk factors were present to varying degrees, none were as predominant. Only captital risk, as reflected by net worth levels, was high, which is hardly surprising. The lack of capital obviously wasn't a causal factor responsible for the failure, but merely confirmation that earnings problems had depleted capital accounts to dangerously low levels.

For 1984 S&L failures we present below a more detailed analysis of overall profitability and the five risk factors.

1. **Overall Profitability.** Profitability in the years prior to closing was dismal for S&Ls that failed in the 1981-1984 period. Of the 164 failures, only five S&Ls had a return on assets above peer levels in the year prior to failure and only two were positive. Additionally, with almost no exceptions, the trend in earnings was consistently downward, with a pronounced worsening in the two years prior to failure.

As one would expect, the critical reason for this poor earnings record is the net interest margin. Again, only five of the 164 S&Ls that failed had margins above peer levels and most were substantially below, with approximately 90% having negative margins.

2. **Interest-Rate Risk.** Here we also look to the behavior of the net interest margin to assess the degree of interest-rate risk that was present in the failed S&Ls. The conclusion is an obvious one: interest-rate risk was the most important factor, in all likelihood the only one, that was responsible for the failure of most, if not all, of these institutions.

From Attachment 1, we can see that the margin worsened steadily through 1982 for all S&Ls. This trend was more pronounced in S&Ls that failed, which suggests that their risk exposure to adverse rate movements was even higher than that of the industry itself. Indeed, the level of the margin was so much lower in the failed S&Ls that it is obvious that these institutions were much more severly affected than the S&L industry by the upward movement of interest rates that began in 1979.

3. **Liquidity Risk.** The critical indicator of the degree of liquidity risk present in a savings and loan is the extent to which it depends on purchased funds, that is, short-term, interest-sensitive funding sources that are above the FSLIC insurance limit. The more an institution funds itself with such large liabilities, the greater its potential for experiencing liquidity problems and the higher its liquidity risk. In reviewing the S&Ls that failed, we found that approximately one-half of them were heavily dependent on purchased funding sources. Interestingly, for S&Ls that failed in 1982, 1983, and 1984, about half of them obtained more than 50% of such funding from their respective Federal Home Loan Bank. In 1984 failures the level was considerably higher, as FHLB Advances accounted for 67% of such funding in almost two-thirds of the cases.

We conclude that the degree of liquidity risk was not a primary cause of S&L failures during this period. While the use of purchased money was significantly higher than peer norms for half of the failed S&Ls, one must also take into account the substantial proportion of FHLB Advances in these institutions.

4. **Asset Quality Risk.** In assessing asset quality risk, we examined the growth of loans, whether the proportion of Other Mortgage Loans was high, whether loan yield was unusually high, indicating the possible presence of higher risk credits, and the amount of Other Real Estate Owned (OREO). With respect to the first three factors, the evidence is clear and overwhelming that there was no widespread relationship between asset quality risk and S&L failures during the 1981-1984 period.

While the conclusion remains the same with respect to OREO, the supporting evidence is not as strong. For S&Ls that failed in 1981 and 1982, the substantial majority had low levels of OREO, with approximately 65% having less than 0.50% of total loans plus OREO. The picture changed for S&Ls that failed in 1983 and 1984, with approximately half having OREO in excess of 1.00% of Loans plus OREO. Since Other Real Estate Owned was not significant for half of the S&Ls that failed in 1983 and 1984 and the levels for failures in the two earlier years were considerably lower, the data certainly support the conclusion reached.

5. **Overhead Risk.** Generally, we would assess overhead risk by examining the proportion of income that is absorbed by overhead. Because the net interest margin squeezed income levels so sharply in savings and loans during this period, this is not an appropriate method. We therefore compared overhead growth in the years prior to failure with earning asset growth.

The evidence clearly indicated that overhead risk was not an important factor in the failure of S&Ls during the four year period examined. The number of S&Ls that failed for which overhead was a significant factor affecting earnings was less than 20%.

6. **Capital Risk.** The level of net worth in the years prior to failure was substantially below that of peer S&Ls. Almost all such institutions had net worth ratios (Net Worth to Assets) at least 200 basis points below peer levels. Also, the level of capital declined steadily during years immediately preceding failure.

In short, the level of capital risk was high for S&Ls that failed, which is hardly a surprising conclusion. However, the capital shortfall did not cause failure, it was merely the reflection of year-after-year of losses, caused almost entirely by the huge degree of interest-rate risk that was present in these institutions.

Relationship between Brokered Deposits and Failure of S&Ls in 1984

Our findings clearly indicate that an outsize degree of interest-rate risk was almost entirely responsible for the failure of savings and loans in the 1981-1984 period. Nonetheless, we will examine specifically the relationship between brokered deposits and 1984 savings and loan failures.

In doing so we must recognize, however, that brokered deposits are merely one form of a larger type of liability generation, namely, purchased funds or large liabilities. Such funding is large denomination (amounts of $100,000 or greater), interest-sensitive and credit conscious. We must therefore examine not only the role, if any, of brokered deposits, but also that of total purchased funding in 1984 S&L failures.

Finally, we will examine the relationship between FHLB Advances and 1984 S&L failures. Since one type of purchased money can be substituted for another, it is difficult to single out a particular category, say brokered deposits, and argue that it causes savings and loan failures, if savings and loans also use other purchased funding sources to an equal or greater extent.

Table 6 indicates the extent to which brokered deposits were present in savings and loans that failed in 1984. Since 10 of the 16 institutions that failed had no such deposits, it is obvious that, in general, brokered deposits do not cause savings and loans to fail. Of the remaining six, two had very small amounts of brokered funds (less than 2% of total deposits) and one had a significant, but moderate level (18.7%). In other words, only three of the 16 S&Ls that failed, less than 20%, had substantial amounts of brokered deposits. It is clear that the data do not support a conclusion that brokered deposits caused S&L failures in 1984.

Let us now examine the extent to which failed S&Ls used all types of purchased funds, the relationship between the level of brokered deposits and total purchased funding, and how each for failed S&Ls compared with the average levels used by comparably sized S&Ls. Tables 7, 8, and 9 present data that permit conclusions about all three issues.

Table 7 indicates that for those failed S&Ls that used brokered deposits, such funding represented less than 50% of total purchased money. In other words, they obtained an equal amount of large denomination funding from other sources. For S&Ls with large levels of brokered funds, such deposits accounted for the predominant proportion of total purchased funding, on average, 72%. It warrants noting that this last sample only contains four S&Ls. Nonetheless, we must examine the reason for such a large percentage.

Such a large proportion may reflect a choice by management to use primarily brokered deposits. Alternatively, S&Ls that failed may not have had sufficient access to other purchased funding sources, which would suggest that brokered deposits might have been used as a last resort.

The data in Tables 8 and 9 clearly indicate that failed S&Ls did, indeed, use purchased funds to a far greater extent than comparably sized S&Ls. The level of such funding was approximately five times that of peer S&Ls. S&Ls that failed were obviously able to obtain large amounts of purchased money other than brokered deposits and those few institutions that used brokered funds heavily could easily have obtained other types of purchased funding. The reduction or elimination of brokered deposits would have made no difference; these S&Ls would have failed regardless.

Those who argue that brokered deposits cause S&Ls to fail do so with little or no empirical support. The data in Table 10 show the pitfalls of asserting that one liability product causes the failure of financial institutions. We examined the extent to which failed S&Ls used Federal Home Loan Bank (FHLB) Advances and how that compared with the levels used by comparably sized S&Ls. The results are startling.

Relative to the total amount of purchased funds used by failed S&Ls, the proportion of FHLB Advances was, on average, a surprisingly high 68.15%. Recall that the use of total purchased funding sources was extremely high for S&Ls that failed in 1984 (See Tables 8 and 9). This, by itself, could be misleading, as that proportion of FHLB Advances usage could hold for all S&Ls. Column four in Table 10 clearly indicates that it does not, as failed S&Ls relied on approximately five times more funding from their FHLB than other S&Ls.

Finally, we examined whether FHLB Advances were largely responsible for the high dependence on purchased money by failed S&Ls. Column six in Table 10 demonstrates that over 100% of the difference between the level of purchased money in failed S&Ls as compared with peer norms for all S&Ls is caused by FHLB Advances. If one wants to argue that a specific liability category causes S&L failures, then the solution is to dismantle the Federal Loan Bank System!

The evidence clearly indicates that brokered deposits were either not present or only present in insignificant amounts in the predominant majority (75%) of 1984 S&L failures. The data also show that S&Ls that failed in 1984 used purchased money to a far greater extent than other comparably sized S&Ls, and therefore, they were able to find funding sources other than brokered deposits. The presence of large amounts of brokered deposits in a few institutions reflected a management choice to use brokered funds; it did not reflect a lack of alternative available sources. Finally, data in Table 10 demonstrate the absurdity of arguing that specific liability products caused S&L failures.

TABLE 1: Incidence of Brokered Deposits, Banks That Failed During Period from January 1 to September 30, 1984

Total Assets (millions)	Number of Failures	Number With No Brokered Deposits	% With No Brokered Deposits
0 - 10	8	7	87.5%
10 - 20	12	6	62.5
20 - 25	12	9	75.0
25 - 40	12	9	75.0
40 - 100	9	3	33.3
100 - 300	6	3	50.0
300 - 500	1	0	00.0
Total	60	37	62.7%

Number with Brokered Deposits, Classified by Percent of Total Deposits

	< 5%	5-10%	10-15%	15-20%	> 20%
0 - 10	0	1	0	0	0
10 - 20	1	1	2	2	0
20 - 25	1	1	0	0	1
25 - 40	1	0	0	1	1
40 - 100	1	2	0	0	3
100 - 300	0	0	0	0	3
300 - 500	0	0	1	0	0
Total	4	5	3	3	8

TABLE 2: Brokered Deposits and Total Purchased Funding Sources, Banks That Failed During Period From January 1 to September 30, 1984*

Total Assets (millions)	Number of Failures	Brokered Deposits to Total Deposits	Purchased Funds to Earning Assets	Purchased Funds to Earning Assets: Peer**	Brokered Deposits to Earning Assets	Brokered Deposits to Purchased Funds
0 - 10	8	0.00%	22.97%	6.27%	0.00%	0.00%
10 - 20	12	0.60	24.31	7.18	0.66	2.82
20 - 25	12	0.00	18.73	8.20	0.00	0.00
25 - 40	12	0.00	27.26	8.71	0.00	0.00
40 - 100	9	6.46	39.80	10.51	8.10	15.62
100 - 300	6	10.28	41.91	14.79	11.33	19.18
300 - 500	1	14.06	80.31	22.10	10.86	13.52
Total	60	0.00%	26.10%	—	0.00%	0.00%

TABLE 3: Brokered Deposits and Total Purchased Funding Sources, Banks with Brokered Deposits That Failed During Period From January 1 to September 30, 1984*

Total Assets (millions)	Number of Failures	Brokered Deposits to Total Deposits	Purchased Funds to Earning Assets	Purchased Funds to Earning Assets: Peer**	Brokered Deposits to Earning Assets	Brokered Deposits to Purchased Funds
0 - 10	1	5.09%	33.26%	6.27%	6.15%	18.49%
10 - 20	6	10.52	24.31	7.18	12.30	41.01
20 - 25	3	6.58	24.87	8.20	7.07	25.58
25 - 40	3	15.80	47.57	8.71	15.30	32.16
40 - 100	6	17.31	41.06	10.51	19.19	38.49
100 - 300	3	23.20	59.05	14.79	23.96	47.57
300 - 500	1	14.06	80.31	22.10	10.86	13.52
Total	23	14.06%	39.81%	—	12.[illegible]3%	36.63%

---

* The data displayed represent the median ratio for each grouping of banks.

** The data displayed in this column represent the median ratio for all banks of comparable size in the nation.

TABLE 4: Distribution Ranges, Brokered Deposits and Purchased Funding Sources, Banks That Failed During Period From January 1, 1984 to September 30, 1984

	Low	First Quartile	Median	Third Quartile	High
Brokered Deposits to Total Deposits	0.00%	0.00%	0.00%	6.46%	53.99%
Purchased Funds to Earning Assets	2.00	17.00	26.10	35.27	80.31
Brokered Deposits to Earning Assets	0.00	0.00	0.00	7.07	65.32
Brokered Deposits to Purchased Funds	0.00	0.00	0.00	20.35	96.07

TABLE 5: Distribution Ranges, Brokered Deposits and Purchased Funding Sources, Banks With Brokered Deposits That Failed During Period From January 1, 1984 to September 30, 1984.

	Low	First Quartile	Median	Third Quartile	High
Brokered Deposits to Total Deposits	0.87%	5.93%	14.06%	23.20%	53.99%
Purchased Funds to Earning Assets	11.78	25.62	39.81	50.36	80.31
Brokered Deposits to Earning Assets	1.01	6.61	12.96	23.96	65.32
Brokered Deposits to Purchased Funds	5.64	15.62	36.63	56.63	96.07

TABLE 6: Incidence of Brokered Deposits, Savings and Loans That Failed During Period From January 1 to September 30, 1984*

Number of Failures	Number With No Brokered Deposits	% With No Brokered Deposits
16**	10	62.5%

Number With Brokered Deposits, Classified By Percent of Total Deposits

<5%	5-10%	10-15%	15-20%	>20%
2	0	0	1	3

TABLE 7: Brokered Deposits and Total Purchased Funding Sources, Savings and Loans That Failed During Period January 1, 1984 to September 30, 1984*

Number of Failures	Brokered Deposits to Total Deposits	Brokered Deposits to Purchased Funds
16**	0.00%	0.00%

Savings and Loans with Brokered Deposits That Failed During Period January 1, 1984 to September 30, 1984

6	22.55%	48.24%

Savings and Loans with Significant Levels of Brokered Deposits That Failed During Period January 1, 1984 to September 30, 1984

4	50.97%	72.23%

---

*The data displayed represent the median ratio for each grouping of banks.

**There were actually 17 failures, but only data for 16 were available.

TABLE 8: Brokered Deposits and Total Purchased Funding Sources Individual Savings and Loans That Failed During Period From January 1 to September 30, 1984

Name		Total Assets (millions)	Brokered Deposits to Total Deposits	Brokered Deposits to Earning Assets	Purchased Funds to Earning Assets	National Purchased Funds to Earning Assets: Peer	Brokered Deposits to Purchased Funds
Union FS&LA	(VA)	$ 8.6	1.62%	1.80%	14.46%	4.33%	12.16%
American S&LA	(MS)	9.4	78.21	214.13	218.27	4.33	98.10
Mitchell Home S&LA	(SD)	18.6	0.87	0.00	7.68	4.52	13.67
Investors SA	(TX)	31.7	0.00	0.00	34.04	5.14	0.00
Windom FS&LA	(MN)	48.4	0.00	0.00	22.92	5.14	0.00
American S&LA	(GA)	61.2	0.00	0.00	49.38	6.40	0.00
Home S&LC	(OH)	77.5	0.00	0.00	2.66	6.40	0.00
Scandia S&LA	(IA)	67.9	0.00	21.51	5.51	6.40	0.00
R.I. FS&LA	(RI)	129.8	0.00	29.56	35.72	9.33	0.00
New North Miss.	(MS)	115.0	18.70	0.00	36.66	9.33	58.67
Queen City	(WA)	233.7	26.40	74.81	78.19	9.33	37.80
Union FS&LA	(IN)	331.9	0.00	0.00	20.81	14.90	0.00
First FS&LA	(ND)	259.2	0.00	0.00	34.57	14.90	0.00
Empire S&LA	(TX)	332.5	75.54	0.00	87.20	14.90	85.79
Century FS&LA	(NY)	734.6	0.00	0.00	10.00	17.79	0.00
Continental FS	(OH)	1041.2	0.00	1.05	25.42	24.13	0.00

TABLE 9: Brokered Deposits and Total Purchased Funding Sources, Peer Comparisons of Individual Savings and Loans That Failed During Period From January 1 to September 30, 1984

Name		Brokered Deposits to Earning Assets Minus Peer	Purchased Funds to Earning Assets Minus Peer	Column (1) ÷ Column (2)	
Union FS&LA	(VA)	1.80%	10.13%	17.77%	
American S&LA	(MS)	214.13	218.27	98.10	
Mitchell Home S&LA	(SD)	0.00	28.90	0.00	
Investors SA	(TX)	0.00	17.78	0.00	
Windom FS&LA	(MN)	0.00	42.90	0.00	
American S&LA	(GA)	0.00	(3.74)	0.00	
Home S&LC	(OH)	0.00	(0.89)	0.00	
Scandia S&LA	(IA)	21.51	27.33	78.70	
R.I. FS&LA	(RI)	29.56	68.86	42.93	
New North Miss.	(MS)	0.00	19.67	0.00	
Queen City	(WA)	74.81	72.30	103.47	
Union FS&LA	(IN)	0.00	(7.79)	0.00	
First FS&LA	(ND)	0.00	11.30	0.00	
Empire S&LA	(TX)	0.00	5.09	0.00	
Century FS&LA	(NY)	0.00	26.49	0.00	
Continental FS	(OH)	1.05	3.16	33.55	
MEDIAN		0.00	18.73	0.00	(60.82)*

* The number in parentheses represents the median value for those S&Ls that had brokered deposits.

TABLE 10: FHLB Advances and Total Purchased Funding Sources, Peer Comparisons of Individual S&Ls that Failed During Period from January 1 to September 30, 1984

Name		(1) FHLB Advances to Earning Assets	(2) Purchased Funds to Earning Assets	(3) Column (1) ÷ Column (2)	(4) Column (1) Minus Peer	(5) Column (2) Minus Peer	(6) Column (4) ÷ Column (5)
Union FS&LA	(VA)	9.95%	14.46%	68.81%	9.95%	10.13%	98.22
American S&LA	(MS)	0.00	218.27	0.00	0.00	218.27	0.00
Mitchell Home S&LA	(SD)	23.08	34.04	67.80	23.08	28.90	79.86
Investors SA	(TX)	19.27	22.92	84.08	19.27	17.78	108.38
Windom FS&LA	(MN)	33.83	49.38	68.50	32.69	42.90	76.20
American S&LA	(GA)	1.01	2.66	37.97	(0.13)	(3.74)	2876.92*
Home S&LC	(OH)	4.91	5.51	89.11	3.77	(0.89)	423.60*
Scandia S&LA	(IA)	12.06	36.66	32.90	8.95	27.33	32.75
R.I. FS&LA	(RI)	20.55	78.19	26.28	17.44	68.86	25.33
New North Miss	(MS)	33.04	34.57	95.57	27.48	19.67	139.71
Queen City	(WA)	0.15	87.20	0.17	(5.41)	72.30	(7.48)*
Union FS&LA	(IN)	6.77	10.00	67.70	(0.05)	(7.79)	15580.00*
First FS&LA	(ND)	23.36	25.43	91.86	13.13	11.30	116.19
Empire S&LA	(TX)	20.53	20.81	98.65	14.97	5.09	294.10
Century FS&LA	(NY)	15.11	35.72	42.30	12.00	26.49	45.30
Continental FS	(OH)	5.52	7.68	71.87	5.52	3.16	174.68
MEDIAN		13.59%	29.74%	68.15%	10.98%	18.73%	107.21

---

*When the level of FHLB Advances or Purchased Funds in an S&L was below peer, the subtraction in columns (4) and (5) resulted in a negative number. In these cases, we examined the actual relationship in order to determine whether the value in column (6) should be positive or negative.

ATTACHMENT 1

ANALYSIS OF S&L MARGIN BY PEER GROUP MEDIANS 1980 THROUGH 1983

Peer Groups (in millions)		1980	1981	1982	1983
$ 10 - 25	Earning Asset Yield	9.93	10.94	11.43	11.40
	Break Even Yield	8.32	10.18	10.96	9.59
	Net Interest Margin	1.61	0.76	0.47	1.87
$ 25 - 50	Earning Asset Yield	9.77	10.69	11.18	11.35
	Break Even Yield	8.23	10.16	10.98	9.83
	Net Interest Margin	1.54	0.53	0.20	1.60
$ 50 - 100	Earning Asset Yield	9.74	10.53	11.00	11.27
	Break Even Yield	8.34	10.22	11.00	9.84
	Net Interest Margin	1.40	0.31	0.00	1.52
$100 - 250	Earning Asset Yield	9.74	10.51	10.97	11.29
	Break Even Yield	8.36	10.30	11.09	9.99
	Net Interest Margin	1.38	0.21	(0.12)	1.48
$250 - 500	Earning Asset Yield	9.78	10.60	11.11	11.34
	Break Even Yield	8.51	10.68	11.40	10.14
	Net Interest Margin	1.27	(0.08)	(0.37)	1.35
$500 - 1 billion	Earning Asset Yield	9.93	10.72	11.20	11.60
	Break Even Yield	8.66	10.81	11.48	10.26
	Net Interest Margin	2.34	(0.09)	(0.28)	1.42
Over $1 billion	Earning Asset Yield	10.07	10.85	11.21	11.54
	Break Even Yield	8.86	11.65	12.06	10.45
	Net Interest Margin	1.21	(0.80)	(0.85)	1.07

Source: Cates Consulting Analysts, Inc.

EXHIBIT VIII

Brokered Deposits: Legislative Alternatives

Merrill Lynch Discussion Paper

As Congress again takes up the issue of insured brokered deposits, we are pleased to see that both the House and the Senate have drafted legislation which recognizes the important distinctions between two segments of the market. Senators D'Amato and Mattingly have introduced a bill in the Senate (S.791) and Congressmen Garcia, Schumer and Barnard in the House (HR107), each of which would curb abuses in the short-term institutional market while preserving the significant benefits provided by the medium-term individual market. Both bills contain provisions which (1) prohibit poorly capitalized institutions from raising insured brokered deposits, and (2) limit the amount of short-term insured brokered deposits any institution may hold.

We believe that addressing the brokered deposit issue in this way will result in an appropriate solution to the problem which exists in the short-term institutional insured market where the practice of "deposit spreading" has developed and where brokered deposits have been found in a number of recently failed banks and thrifts.

The purpose of this paper is to discuss the basis for exempting medium and long-term brokered deposits from any restrictions placed on the use of brokered deposits by healthy depository institutions.

The individual saver/medium-term market is not part of the problem.

The individual saver/medium-term market which Merrill Lynch and other full-service brokerage firms serve is simply not part of the problem which the FDIC and FHLBB are trying to solve.

Of 93 thrifts that failed during 1982 and 1983 (data is unavailable on the other eight which failed during this period), 77 had no brokered deposits, and only nine had brokered deposits in excess of 5% of total deposits. Further, none of the failed thrifts had issued CDs through national brokerage firms where medium-term, fixed-rate CDs are placed with individual savers in small denominations. In fact, of the hundreds of bank and thrift failures in the last few years, we know of only one instance in which funds raised in the individual saver market were found in a failed bank. These funds were not a significant percentage of deposits, and in no way contributed to the failure.

The potential for abuse in the segment is limited.

It does not seem logical to eliminate a market which benefits individuals and sound financial institutions (particularly those not large enough to have their uninsured deposits protected by the implicit guarantee of the federal insurance agencies) when it has not been part of the problem. Furthermore, certain characteristics of the medium-term market make it very unlikely that the number and kinds of abuses which have plagued the short-term institutional market would shift to the medium-term market if exempt from restrictions.

If such a shift were probable, it would have occurred already. After all, money brokers are certainly not averse to operating in additional profitable markets. Many issuing institutions certainly prefer the more stable source of funds and rates offered by the medium-term market. In fact, the desire to use this market is demonstrated by the many institutions which are accessing it through Merrill Lynch and other nationally recognized brokerage firms.

So why haven't the money brokers expanded their "deposit spreading" business into the medium-term market? First, the institutional investors which money brokers serve demand liquidity. A one year CD is not liquid unless the brokers willingly make secondary markets, which they won't do, due to a justifiable fear of the credit risk in holding CD positions, and a lack of capital. Second, even if the brokers made secondary markets, the potential loss to the investors upon the sale of a CD in poor markets would preclude their involvement.

The customer base for medium and long-term deposits is predominantly individual and not institutional in nature. For the money brokers who have been associated with the abuses in the short-term market to shift their activities to the medium-term market, one of two things must happen: the broker must either develop an individual customer base, or he must convert his existing institutional investor base to medium-term investors.

It is extraordinarily difficult to develop a customer base of individual investors. Brokerage firms, banks and thrifts have, of course, spent billions of dollars over the last two decades doing just that. Lacking such a customer base, it is unlikely that unregulated brokers would be willing or capable of making the investment necessary to build that customer base today. Without a proprietary relationship with a base of individual investors, brokers cannot effectively distribute medium-term CDs.

It is also highly improbable that the money brokers would be able to shift their existing institutional clients from short-term CDs to medium or longer-term CDs. Many of these institutions (such as credit unions and thrifts) have maturity guidelines that limit them to the short-term markets. Further, these institutional investors are most often investing temporarily surplus cash and cannot extend their investments to the medium-term.

Most important, depositors demand the liquidity of a secondary market to extend maturities, and maintaining a secondary market requires capital and a dependable credit approval process on the part of the broker. The longer the maturity, the more important a secondary market becomes. The unregulated money brokers do not provide a secondary market in the CDs they sell since they typically do not perform credit reviews of the depository institutions they serve and, thus, would not want to hold secondary positions -- even if they had the required capital to do so.

Moreover, it is unlikely that such brokers and their institutional customers would accept the interest rate risk associated with purchasing long-term CDs with the intention of selling them prior to maturity in a secondary market. For example, a two-year CD is valued in the market at something other than par immediately after its sale, and its value depends on the direction of interest rates and rate spreads. Neither the investor nor the broker would be willing to take the risk of loss should rates or spreads increase during the period.

A similar risk exists with floating rate CDs. For example, a three-year floating rate CD may be placed today paying .25% above a Treasury bill index. However, a similar floating rate CD might be priced next month at .50% above the same index. The existence of the second floating rate CD drives down the market value of the first CD.

Restricting this segment will eliminate significant benefits.

Restricting the insurance available on medium-term, brokered deposits would deny sound institutions access to (1) an incremental source of funds which may currently be lodged in money market funds and other investments (for example, IRA and Keogh funds held with brokerage firms would not be available as deposits to financial institutions), (2) term deposits not likely to be withdrawn early due to the secondary market maintained by brokerage firms, (3) funds with which to generate new housing and other productive loans locally, and (4) an important cost-effective funding alternative.

A "cap" which fails to distinguish between short-term and longer-term deposits, for example, would deny small and medium-sized institutions access to broad financial markets which are readily available to larger banks and thrifts. The individual saver/medium-term market served by Merrill Lynch and the other national brokerage firms is arguably the most cost-effective source of fixed-rate, medium-term funds available to regional banks and thrifts institutions today, often even more cost-effective than advances from the Federal Home Loan Banks.

If insurance is not maintained for medium-term brokered deposits, sound institutions legitimately seeking medium-term, fixed-rate funds would be forced to compete with the weakest institutions, on the basis of rate only, through deposit listing services, direct marketing and national advertising. This, in turn, will drive the sound institutions out of the market for cost reasons. In contrast, in the individual insured brokered deposit market, a sound institution is not forced to compete rate-wise with the "highest bidders" because the credit screens conducted by national brokerage firms eliminate the weakest institutions.

Restriction of the medium-term market also denies the individual saver access to a convenient means of making a bank or thrift deposit, a variety of maturities from which to select, competitive rates and secondary markets -- priviledges that institutional investors with large deposits have had for years. Since the Depository Institutions Deregulation Committee permitted insured brokered deposits two years ago, more than one million savers have chosen to make bank and thrift deposits through national brokerage firms -- a strong testimony to the value of this service to individuals. Many of these individuals hold their CDs in IRA or Keogh accounts and exempting medium and long-term maturities, which are ideally suited to retirement accounts, will preserve the substantial benefits of brokered deposits to this consumer group.

Proposed legislation combined with improved regulation will solve the problem.

Merrill Lynch continues to support measures to improve monitoring and control of deposit growth at weak financial institutions, and we are encouraged by the steps the regulators have recently taken to require reporting of brokered deposits and deposits placed directly by financial institutions and to restrict the growth of poorly capitalized institutions. All depository institutions should, in addition, be required to report deposits on a frequent basis, and those which are growing rapidly (using brokers or direct marketing techniques) should be singled out for special attention. Given the new found ability of depository institutions to grow rapidly through interest rate freedom, an efficient regulatory system to detect rapid growth, by whatever means, is essential.

We believe that the proposed legislation combined with improved regulatory monitoring and control will eliminate abusive deposit brokerage practices while preserving the significant benefits provided by the longer-term market, in particular.

Senator GORTON. Thank you, Mr. Falzon.

Mr. Coloma.

STATEMENT OF JORGE COLOMA, PRESIDENT, FAIC SECURITIES, INC.

Mr. COLOMA. Mr. Chairman and members of the subcommittee, my name is Jorge Coloma. I am president of FAIC Securities, Inc., Miami, FL.

I appreciate the opportunity to express our views on an issue of critical concern to our company.

On January 16, 1984, the FDIC and the Federal Home Loan Bank Board announced a proposal to severely restrict the insurance of brokered deposits placed in federally insured banks and thrift institutions. In March 1984, in connection with the proposed regulations, we testified before a subcommittee of the House Committee on Government Operations about how the regulators could respond to their concern that insured deposit brokerage might contribute to the thrift crisis and expose the insurance funds to added risks.

The regulations proposed at that time by the FDIC and the Federal Home Loan Bank Board to limit insured deposit brokerage threatened the existence of the deposit brokerage industry. We articulated less onerous regulatory alternatives to allay the concerns of the regulators.

Despite unprecedented opposition, the FDIC and the Federal Home Loan Bank Board went forward without substantial revision with a final version of the regulations on March 26, 1984.

Accordingly, FAIC had no alternative but to reluctantly initiate a lawsuit in Federal court to halt the unlawful action of the regulators. In June 1984, the Federal District Court for the District of Columbia held that the regulators' action was unlawful.

The regulators have accomplished many of their original objectives. They have, in fact, limited the exponential growth of depository institutions by requiring that growth in deposits be linked to graduated increases in net worth; limited direct new investments; required periodic reports by depository institutions to the regulators on the level of their brokered deposits; and capped the acquisition by a depository institution of brokered deposits to 5 percent of its total assets if the institutions's net worth falls below 3 percent of its liabilities.

The adoption of these less onerous alternatives was due in large part to congressional efforts to restrain the actions of the regulators as expressed through numerous introduced bills, hearings, letters of concern, and much appreciated hard work.

Most knowledgable people are learning that the deposit brokerage industry is not the source of the multitude of problems that seem to threaten to overwhelm the regulators.

BENEFITS OF INSURED DEPOSIT BROKERAGE

Insured deposit brokerage provides investors, depository institutions, and the overall economy many benefits. They include: Enabling small- and medium-sized depository institutions to compete for funds with the largest banks and savings and loan associations throughout the country; providing liquidity to individuals and institutions; permitting depository institutions to obtain deposits at interest rates and maturities that will better match the characteristics of their loans; and enabling depository institutions to effectively compete for funds with other entities.

In January 1985, a three-judge panel of the U.S. Court of Appeals for the District of Columbia affirmed the district court decision invalidating the proposed regulations. By ruling that deposits placed through deposit brokers receive full Federal deposit insurance, the court of appeals, as a result of FAIC's concerted efforts, placed its formal stamp of approval on a nationwide system of insured deposit brokerage.

On April 25, 1985, the House Subcommittee on Commerce, Consumer and Monetary Affairs issued a new report on brokered deposits entitled, "New Findings on Brokered Deposits." It concluded that:

> There appears to be no current need for the kind of severely restrictive regulation or restriction on brokered funds that the FDIC proposed in 1984 and has continued to advocate in the current session of Congress.

We agree. However, the report did not focus on the problems we as businessmen are confronted with in this area.

Since the proposed regulations were published, FAIC has suffered an erosion of customers who have chosen not to place deposits through FAIC, given the attitude of the regulators. Despite two court decisions unfavorable to the regulators' position, within a few weeks the regulators are expected to make a formal request for a judicial review of the previous decisions by the entire U.S. Court of Appeals for the District of Columbia. The regulators have not rescinded their regulations, and one regulator has sent out a signal that it still intends to, "* * * consider other methods of fulfilling its mandate with regard to the use of brokered deposits by all institutions."

Despite all our efforts, the regulatory atmosphere is still contentious as the regulators have continued to make speeches and issue press releases about the dangers of insured brokered deposits. Recently, in a new assault on brokered deposits, the FDIC identified banks, thrift institutions, and credit unions that had placed funds through deposit brokers in two banks that failed. It was a clear attempt to embarrass and intimidate deposit brokerage customers.

We continually hear from depository institutions that they are being pressured strongly by Federal examiners on their brokered deposits, whether they are investors or receivers of brokered funds. The effect has been to put our customers in a difficult position and endanger important and crucial business relationships.

ATTEMPT OF RECONCILIATION

In light of these events, FAIC believes it must try to find a means to a reconciliation between the regulators and the deposit brokerage industry. In a spirit of cooperation, FAIC in recent weeks has worked with the FDIC, the Congress, and other members of the deposit brokerage industry to fashion a congressional solution that would respond to the residue of the regulators' concerns and facilitate a more reasonable business climate.

I have proposed what I believe is a reasonable and logical solution that all the parties might be able to live with, albeit with some significant sacrifices. This proposal places a cap of 20 percent of deposits on insured brokered deposits at a depository institution when it meets its minimum net worth requirements; places a prohibition on any insured brokered deposits at a depository institution when it fails to meet its minimum net worth requirements, as determined by the regulators; restricts a depository institution from having more than 25 percent of its maximum allowed insured brokered deposits maturing in any one 3-month period; requires deposit brokers to report to the Federal regulators key information about brokered deposits; and provides the regulators with extensive authority to regulate other potential abuses of the free market system of funds placement, but prohibits discrimination against insured brokered deposits.

One issue that remains to be resolved is the concern expressed by the FDIC that the standards for deposit brokerage for both the FDIC and the Federal Home Loan Bank Board should be uniform. This is difficult, because as we attempt to limit deposit brokerage as a function of net worth we find that the relative net worth of the commercial bank, the mutual savings bank, and the savings and loan industries are substantially different. FAIC has attempted to respond to the FDIC's concern by proposing that the regulators collaborate in efforts to develop uniform standards.

Mr. Chairman, I urge you and the members of the subcommitte to consider this effort and help us work toward a speedy, balanced, and fair resolution of the issues.

In conclusion, I believe the proposal I have outlined today reflects a more up to date view of the needs of the regulators and the deposit brokerage industry that we hope will help restore a more normal business atmosphere to the deposit brokerage industry.

FAIC appreciates the opportunity to appear before the subcommittee and would be pleased to answer any questions and provide further information as needed.

[The complete prepared statement follows:]

FAIC SECURITIES, INC.
2600 S. W. 3rd Avenue
Miami, Florida 33129
Telephone: (305) 858-2519

TESTIMONY
OF
JORGE H. COLOMA

PRESIDENT,
FAIC SECURITIES, INC.
MIAMI, FLORIDA

BEFORE THE
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS
AND CONSUMER AFFAIRS
OF THE
SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
ON
DEPOSIT BROKERAGE REGULATION LEGISLATION

June 5, 1985

FAIC

Mr. Chairman and members of the Subcommittee, my name is Jorge Coloma. I am President of FAIC Securities, Inc. */ ("FAIC"), which is located in Miami, Florida. We appreciate the opportunity to express our views on an issue of critical concern not only to our company, the largest insured certficate of deposit broker in the nation, but to the nation's financial community and almost two million members of the public that are investors through brokers in certificates of deposit.

On January 16, 1984, the Federal Deposit Insurance Corporation ("FDIC") and the Federal Home Loan Bank Board ("FHLBB") announced a proposal to severely restrict the deposit insurance of brokered deposits placed in Federally-insured banks and thrift institutions. In March, 1984, in connection with the proposed regulations by the FDIC and the FHLBB, we testified before a Subcommittee of the House Committee on Government

---

*/ FAIC Securities, Inc. is the largest insured certificate of deposit broker in the United States. FAIC is registered as a broker-dealer under the Securities Exchange Act of 1934 and is a member of the National Association of Securities Dealers, Inc. Established in mid-1980, FAIC today places over $600 million in certificates of deposits each month. FAIC has one of the largest trading rooms in the Southeast and employs over 100 persons. FAIC has placed over $9 billion in certificates of deposit with more than 700 Federally-insured depository institutions, mostly small and medium-sized commercial banks and savings and loan associations. FAIC has more than 4,000 institutional and individual investors. These depositors include financial institutions (including credit unions), pension funds, State, local and Federal governmental entities, school districts, Indian tribes, religious organizations and hospitals. FAIC's offices are located at 2600 S.W. 3rd Avenue, Miami, Florida, 33129; and its telephone number is (305) 858-2519.

Operations about how the regulators could respond to their concern that insured deposit brokerage might contribute to the thrift crisis and expose the insurance funds to added risks. The regulations proposed at that time by the FDIC and FHLBB to limit insured deposit brokerage were overbroad and threatened the existence of the deposit brokerage industry. We articulated less onerous regulatory alternatives to allay the concern of the regulators. For example, we urged the regulators to regulate deposit growth by requiring an increase in deposits to be matched by a proportionate increase in capital and to require the deposit brokerage industry itself to report to the regulators about funds placement.

Despite unprecedented opposition from the large majority of nearly seven thousand commentators, including members of both Houses of Congress and other Federal financial industry regulators and the Department of Justice, the FDIC and FHLBB went forward without substantial revision with a final version of the regulations on March 26, 1984. FAIC believed there was no rational basis for the regulators' conclusion that a limitation of Federal insurance coverage for brokered deposits would be reasonably responsive to their concerns about the safety and soundness of depository institutions and the insurance funds.

Accordingly, FAIC had no alternative but to initiate an action of March 26, 1984, in Federal Court to halt the unlawful action of the regulators. In June, 1984, Judge Gerhard Gesell of the Federal District Court for the District of Columbia held that the regulators' action to impose a $100,000 limitation on insuring brokered deposits for all funds placed by any one deposit broker in a single depository institution was unlawful; set aside the regulations; and enjoined their application.

On September 28, 1984, the House Subcommittee on Commerce, Consumer and Monetary Affairs of the House Committee on Government Operations issued a report on Federal Regulation of Brokered Deposits In Problem Banks and Savings Institutions, which stated that:

> ... agency rules or legislation to restrict the insurance coverage just of brokered deposits, or to place a cap specifically on the brokered funds holdings of banks and thrifts, will not deal effectively with the problem of excessively rapid growth and risky lending by problem institutions.

The report recommended as alternatives: strengthening supervisory control over problem institutions; increasing capital standards; increasing public reporting of brokered deposits; and reducing incentives for depository institutions to take excessive risks with their investments. These alternatives reflected many of the comments submitted to the regulators on their proposed regulations and were consistent with the alternatives recommended in FAIC's testimony.

The regulators accomplished many of their original objectives through adoption of these alternatives. They have, in fact:

- limited the exponential growth of depository institutions by requiring that growth in deposits be linked to concommitant, graduated increases in net worth;
- limited direct new investments to 10 percent of liabilities or twice net worth -- larger investments would require securing prior approval from the regulators;
- required periodic reports by depository institutions to the regulators on the level of their brokered deposits;
- proposed other increases in capital requirements;
- capped the acquisition by a depository institution of brokered deposits to 5 percent of its total assets if the institution's net worth falls below 3 percent of its liabilities; and
- increased deposit insurance premiums or proposed basing them on risk.

The adoption of these less onerous alternatives was due in large part to Congressional efforts to restrain the actions of the regulators as expressed through numerous introduced bills, hearings, letters of concern, and much appreciated hard work.

These less onerous alternatives were prudent and rational responses to what are the regulators' real concerns -- the safety and soundness of depository institutions and the solvency of the respective insurance funds. Everyone is learning that the deposit brokerage industry is not the source of the multitude of problems that seem to threaten to overwhelm the regulators. As the regulators themselves have admitted, the perceived risks to their respective insurance funds are "the handiwork of incompetent or unscrupulous ... managers who have gambled away ... insured deposits on high-risk investments or outright fraud."

Insured deposit brokerage provides investors, depository institutions, and the overall economy many benefits. They include:

- permitting individuals and small investors to obtain the most attractive interest rates and range of maturities wherever in the country they may be offered;
- permitting individuals and small investors to have the benefit of the attractive rates available for larger denomination deposit instruments;
- enabling small and medium-sized depository institutions to compete for funds with the largest banks and savings and loan associations, thereby facilitating the movement of funds from capital-surplus to capital-deficit areas;

- providing liquidity to individuals and institutions by facilitating the purchase and sale of deposit instruments, especially short-term deposit instruments in secondary markets;
- permitting depository institutions to obtain deposits at interest rates and maturities that will better match the characteristics of their loans;
- enabling depository institutions to effectively compete for funds with other entities, such as money market funds, thereby increasing the financial safety and soundness of those depository institutions;
- increasing funds available for housing loans by attracting new funds to depository institutions; and
- reducing the institutional costs for depository institutions of establishing and maintaining accounts.

In January of 1985, a three judge panel of the U.S. Court of Appeals for the District of Columbia affirmed the District Court decision invalidating the proposed regulations. By ruling that deposits placed through deposit brokers receive full Federal deposit insurance, the Court of Appeals, as a result of FAIC's concerted efforts, placed its formal stamp of approval on a nationwide system of insured deposit brokerage.

On April 25, 1985, the House Subcommittee on Commerce, Consumer and Monetary Affairs of the House Government Operations Committee issued another report on brokered deposits entitled New Findings on Brokered Deposits. It concluded that:

> ... there appears to be no current need for the kind of severely restrictive regulation or restriction on brokered funds that the FDIC proposed in 1984 and has continued to advocate in the current session of Congress.

We agree. However, the report did not focus on the problems we as businessmen are confronted with in this area.

Since the proposed regulations were published, FAIC has suffered an irreparable loss of customers who have chosen not to place deposits through FAIC given the attitude of the regulators. Despite two court decisions unfavorable to the regulators' position, within a few weeks the regulators are expected to make a formal request for a judicial review of the previous decisions by the entire U.S. Court of Appeals for the District of Columbia. The regulators have not rescinded their regulations, and one regulator has sent out a signal that it still intends to "... consider other methods of fulfilling its mandate with regard to the use of brokered deposits by all institutions." Despite all our efforts, the regulatory atmosphere is still contentious as the regulators have continued to make speeches and issue press releases about the dangers of insured brokered deposits. Recently, in a new assault on brokered deposits, the FDIC identified banks, thrift institutions, and credit unions that had placed funds through deposit brokers in two banks that failed. It was a clear attempt to embarrass and intimidate deposit brokerage customers. The FDIC also announced recently that troubled banks hold more than $9 billion of the $24 billion in brokered deposits in the banking industry. We continually hear from depository institutions that they are being pressured strongly by Federal examiners on their brokered deposits. The effect has been to put our customers in a difficult position and endanger important and crucial business relationships.

In light of these events, FAIC believes it must try to find a means to a reconciliation between the regulators and the deposit brokerage industry. In a spirit of cooperation, FAIC in recent weeks has worked with FDIC Chairman Isaac, his staff, the Congress, and other members of the deposit brokerage industry to fashion a legislative compromise that would respond to the residue of the regulators' concerns and facilitate a more reasonable business climate.

After weeks of discussion with many of the key parties, I have proposed what I believe is a reasonable and logical compromise, that all the parties might be able to live with, albeit with some significant sacrifices. The proposed compromise (hopefully to later be embodied in legislation):

- places a cap of 20 percent of deposits on insured brokered deposits at a depository institution when it meets its minimum net worth requirements;
- places a prohibition on any insured brokered deposits at a depository institution when it fails to meet its minimum net worth requirements, as determined by the regulators;
- restricts a depository institution from having from any one deposit broker more than 25 percent of its maximum allowed insured brokered deposits maturing in any one three-month period;
- requires deposit brokers to report to the Federal regulators key information about brokered deposits that will help the regulators anticipate and limit potential imprudent uses of those funds by the management of insured depository institutions; and
- provides the regulators with extensive authority to regulate other potential abuses of the free market system of funds placement, but prohibits discrimination against insured brokered deposits.

However, there is one major thorny issue that remains to be resolved. It is the concern expressed by the FDIC that the standards for deposit brokerage for both the FDIC and FHLBB should be uniform. This is difficult, because, as we attempt to limit deposit brokerage as a function of net worth, we find that the relative net worths of the commercial bank, the mutual savings bank, and the savings and loan industries are substantially different. FAIC has attempted to respond to the FDIC's concern by proposing that the regulators collaborate in efforts to develop uniform deposit brokerage standards.

Mr. Chairman, I urge you and the members of the Subcommittee to consider this effort at a compromise and help us work towards a speedy, balanced, and fair resolution of the issues. I recommend this approach to you for several reasons.

It will restore a healthy business climate to the deposit brokerage industry.

More importantly, it recognizes the remaining concerns of the regulators.

It treats deposit brokers on an even-handed basis.

In conclusion, I believe the potential legislative compromise I have outlined today reflects a more up-to-date view of the needs of the regulators and the deposit brokerage industry that we hope will help restore a more normal business atmosphere to the deposit brokerage industry.

FAIC appreciates the opportunity to appear before the Subcommittee and would be pleased to answer any questions and provide further information as needed.

Senator Gorton. Thank you, Mr. Coloma.
Mr. Goldsmith.

STATEMENT OF BILL GOLDSMITH, EXECUTIVE VICE PRESIDENT, PROFESSIONAL ASSET SECURITIES, INC.

Mr. Goldsmith. Mr. Chairman, thank you for giving me this opportunity to present our views on problem institutions.

Your committee has in its possession my written testimony supported by accompanying documented study.

Senator Gorton. It does, and it will be incorporated in the record.

Mr. Goldsmith. My presentation this morning will revolve around two of the studies from the House Committee on Banking, one study from Cates Consultings, one study from Golembe & Associates of Washington.

In addition to documented testimonies in quotes from former Comptroller of the Currency, Mr. Conover, from former Senator John Tower, from a Morgan Guaranty survey, from Representative Fernand St Germain, from Attorney General Edwin Meese III, from a Department of Justice report, from Mr. Edwin Gray, from Mr. Bill Isaac, and from Mr. Alan Whitney, and others.

Discussions by Mr. Gray and Mr. Isaac that I heard earlier today and that have been echoed for the past 3 years on the perils to the insurance system always begins with a conclusion before identifying the problems. They have repeated these cries for so long that they have even convinced some of my colleagues at this table.

As you suggested in your opening statement, we might first want to isolate the dangers before recommending a solution.

Chairmen Isaac and Gray's approach can be likened to a doctor with a sick patient who tells his patient to take two aspirin and go to bed and then ask him what his problem is.

BANKS FAIL FOR THREE REASONS

I think that we all can agree that banks fail for three main reasons:

One, banks fail because they are mismanaged. In the Time Magazine article, December 3, 1984, Mr. Isaac said:

> Bankers got many of their current problems the old-fashioned way—they earned them. A common thread in the industry's trouble is bad management.

David Cates, a highly regarded bank and thrift analyst and head of Cates Consulting, was quoted in the American Banker, May 29, 1985, when he said, "Banks fail quite simply because of mismanagement."

Two, more commercial bank failures are due to fraud than for any other single reason.

Attorney General Edwin Meese III announced plans for a multiagency attack on bank fraud, which he said had been a factor in more than half of the bank failures over recent years. Mr. Meese said that in 1984 there were 79 bank failures and 27 failures of thrifts, a record number since the beginning of Federal controls in the 1930's.

According to a Justice Department survey of 75 FDIC-insured banks that failed between 1980 and 1983, 61 percent involved "actual or probable criminal misconduct by bank insiders."

Three, regulatory ineptness has been a contributing factor in recent bank failures.

> Regulatory ineptness contributed to bank failures,

said David Cates.

> Of those banks that failed during the 1981 and 1983 period, only 37 percent had an adverse rating based on the last exam before failure, and 34 percent got a clean bill of health from regulators on their last exam prior to collapse.

The Wall Street Journal on July 16, 1982, on the closing of Penn Square Bank, quoted Representative St Germain when he said:

> Hundreds of investors placed money in an institution which an agency of the U.S. Government knew to be unsound. Public moneys were used to examine the bank, collect data, analyze the condition, but the public did not receive the results of the work for which they paid.

New York Times, November 16, 1983, states that a House committee report on the collapse earlier that year of the Tennessee and Kentucky banking empire controlled by the Butcher brothers criticized the staff of the FDIC for extreme regulatory neglect in failing to take stronger action against the bank's senior officials and that Jake and C.H. Butcher engaged in an unrelenting series of unsafe and conceivably unlawful banking practices over 6 years.

Mr. Alan Whitney, a spokesman for the FDIC, said the agency would be the first to admit that we made a mistake in supervising United American Bank.

Jake Butcher recently pleaded guilty to fraud charges and has been sentenced to 20 years in jail.

Edwin Gray, Chairman of the Federal Home Loan Bank Board, admitted during congressional hearings in April 1984 that his agency might have been able to prevent Empire Savings of Texas' failure if it had acted faster and more decisively.

Yet the FDIC and the FHLBB would have us believe that all the problems with banks and thrifts today begin and end with brokered deposits, when in fact, according to a recently completed study by Ray Garea, executive vice president of Cates Consulting, only 7 percent of all deposits in all bank failures from January 1, 1984, through September 30, 1984, were brokered funds; that sources other than brokered deposits in all failed institutions covered in the Cates study were present in greater abundance than brokered deposits.

The Morgan Guaranty survey of 1984 says even if brokered deposits were banned altogether depository institutions could continue to obtain funds by other means, such as widespread advertising.

However, if we must isolate a single source of deposits as a cause of thrift failures, consider that in 16 thrifts that failed from January 1, 1984, through September 30, 1984, according to this same Cates study, 30 percent of the earning assets in these institutions were funded by purchased money in general, from all sources, but 14 percent, almost half, were supplied by various FHLBB district banks. Yet no one has seriously suggested doing away with district banks. It might not be a bad idea.

You can legislate out of existence brokered deposits, or even put an arbitrary cap on them, but that will not solve the concerns of the regulators. The answer is a resounding "No." Listen to some evidence taken from a House of Representatives Committee on Banking.

This analysis concludes that there is neither concrete evidence nor coherent argument that insured deposit brokerage is inherently harmful to the banking system. Removal of deposit insurance coverage for brokered deposits, as attempted by the agencies in their rule, cannot be justified by the evidence the agencies themselves have presented, and it is also doubtful that capping every institution's holding of brokered funds at some specific percent of deposits will have much effect.

The study further states:

> There is ample demonstration in the statistical materials that among problem institutions rapid growth without brokered funds is much more common than rapid growth with brokered funds. In other words, substitutes appear to be readily available for institutions that are denied access to brokered funds.

As a matter of fact, objective observers, bank analysts, Senators, Congressmen and Congresswomen from both parties, and even Mr. Isaac concede that brokered deposits and brokers provide a valuable service.

In his testimony on October 27, 1983, before a House subcommittee, Mr. Isaac said, "Many money brokers have performed responsibly." The benefits they have provided to both financial institutions and investors need only to be highlighted here. The financial institution that uses the brokerage service to market its CD's can realize important cost savings through reduced staffing and paperwork requirements.

FLEXIBILITY TO PROVIDE FOR SMALL BANKS AND THRIFTS

Another advantage is that the institutions can have flexibility with respect to the amount and maturities of the CD it issues. This flexibility in turn can enable an institution to better match its assets and liabilities. Most important, perhaps, is the access to national money markets that a broker can provide, particularly to smaller banks and thrifts.

Would the real Mr. Isaac please stand up.

Further, it is a fact that about 25 of the largest banks and thrifts hold about 30 percent of all deposits in the United States. If you limit brokered deposits, you would further consolidate deposits in the larger too-big-to-fail banks and thrifts, force well managed banks and thrifts to rely on more costly alternative sources for deposits, reduce the flexibility of bank and thrift managers to practice asset-liability management techniques that can immunize an institution from interest rate risks in almost any interest rate environment, reduce bank and thrift earnings at a time when positive spreads have narrowed to near record lows, raise the cost to consumers for all bank and thrift services. Not prevent banks or thrifts from making bad loans or indulging in risky investments; not eliminate fraudulent or illegal banking practices or insider dealing; and finally, would not force regulators and examiners to act more quickly and prudently to stop these above-mentioned practices.

There is no need to alter the deposit delivery system to capture an errant messenger or two. Mr. Gray's and Isaac's horror stories concerning linked financing involved a few banks and allegedly one broker. There were just as many bankers who turned down this linked financing approach as too risky.

If a few bankers or brokers break the rules, don't change the rules; throw the few out of the game.

Finally, Mr. Isaac and Mr. Gray seem to forget, conveniently, that during the period of 1981–85, when we had more bank failures than in any like period since the 1930's, that during this time we had record high-interest rates, a depression in the oil patch, a recession in the real estate industry, a catastrophe in the Farm Belt. Were none of these problems responsible for bank troubles? Or were all the problems created by brokers?

However, we still believe that some legislation is necessary to deal with the concerns of the regulators, in the House and the Senate, because in the absence of legislation we have had well meaning but disruptive regulation, and lacking either legislation or regulation, the Nation's banks and thrifts are today being subjected to a well calculated campaign of intimidation by FDIC and FHLBB field examiners against the use of brokered deposits. Not only the so-called weak institutions, but also well managed banks and thrifts that meet or exceed regulatory minimum standards.

The result of this intimidation, from interviews with close to 100 officers of banks and thrifts in the last 2½ months, has been a shift away from brokered deposits to other sources of deposits and an increase in the cost of these deposits from 50 basis points to 150 basis points.

Mr. Chairman, you can with legislation address all the concerns that you may have concerning problem banks and the concerns of the regulators articulated by Mr. Gray.

These were quoted on January 17, 1984, in the American Banker, when Mr. Gray said:

> The issue we take up today on the appropriateness of an unregulated financial entity collecting funds, charging a sizable fee, the placing of funds without regard to the safety and soundness of a recipient depository institution, and without regard to the potential consequences of the Federal deposit insurance fund.

SUGGESTIONS FOR LEGISLATION

Therefore, based on our written testimony and the supporting documentation attached thereto we respectfully recommend the following suggestions as a basis for legislation on brokered deposits. We are confident that they meet and even exceed the stated concerns of the regulators.

One, register all brokers with NASD. For more than 50 years the NASD has been an effective regulatory body with a long and distinguished history in the regulation of the securities industry.

Two, require all brokers of certificates of deposit to deal only with commercial banks and thrifts which meet or exceed regulatory minimum standards. Brokers would be required to do a financial analysis of the institutions they perform a deposit brokerage service for at least semiannually. This analysis can be done in-house or purchased from one of several outside firms.

Additional financial disclosure is called for by Chairman Isaac of the FDIC but not endorsed by Chairman Gray. And more timely reporting would be helpful.

Three, require all deposit brokerage firms to report quarterly to the appropriate agencies the name of each institution for whom they provide service and the amount of dollars brokered during the preceding quarter.

Four, require all deposit brokerage firms to refrain from providing service to any institution which does not meet regulatory minimums without written permission from the appropriate agency. This will meet those special circumstances such as American Savings where the regulators themselves asked a group of brokers to raise $1 billion in deposits.

Five, the provision in S. 2851 calling for caps in brokered deposits should be removed since the concerns of the regulators are met by other proposals.

Six, brokers should be required to provide their client depositors with financial information on the fundamental strength and performance of the institution receiving funds. This would increase market discipline.

Seven, institutions should be required to disclose information on their loan portfolios, including a general description of the types of loans, percentage of loans in each category, and a disclosure of nonperforming loans in each category.

Mr. Chairman, thank you for this opportunity, and I welcome any questions from the committee.

[The complete prepared statement follows:]

TESTIMONY OF
WILLIAM A. GOLDSMITH
EXECUTIVE VICE PRESIDENT
PROFESSIONAL ASSET SECURITIES, INC.
MEMBER NASD

Mr. Chairman:

Thank you for this opportunity to discuss the issue of "Brokered Deposits" and to air not only our views and those of many in our industry, but also the views of those more acutely affected by your deliberations and legislation. We also speak for those who use brokers to aid in their search and selection of viable banks and thrifts for their investments, and for those viable, well-managed banks and thrifts who want and need access to a national marketplace for deposits on the most efficient, least costly basis possible.

It is our belief that some legislation is necessary because in the absence of equitable legislation, capricious and counterproductive regulations no matter how well-meaning, have filled the vacuum -- regulations that ultimately proved harmful to the very banks and thrifts these regulations were intended to assist. Even Chairman Issac has said that until and in the absence of legislation, he will use the regulatory powers at his disposal to solve in his way what he perceives as problems created by brokered deposits -- but expressed his desire for legislation to address the issue.

Further, it is our belief that legislation is the proper legal recourse since both a Federal District Court and a U.S. Court of Appeals declared that recent regulatory efforts to curb or eliminate brokered deposits exceeded the authority of the agencies that promulgated them and further declared that any solution to regulatory concerns, real or imagined, falls under the aegis of Congress.

And, finally, we believe that congressional legislation is the correct answer to concerns raised by brokered deposits, since it is Congress and not the regulatory agencies that is elected by and must answer to the constituencies legislation of this magnitude will affect: individuals, borrowers and investors; churches and other religious organizations; charities; cities, counties, and other government agencies; trade groups; corporations; retirement funds; senior citizens; commercial banks and thrifts as investors in and issuers of brokered CDs; credit unions. In one way or another, legislation on brokered deposits will touch almost every man, woman and child, Republicans and Democrats alike, in these United States.

We, of course, recognize that this legislation must address the concerns of the regulators, but it must also consider the needs of investors, individual and institutional alike, who use brokers and the smaller, less visable but well-managed banks and thrifts who rely on brokers to sell their CDs, and by so doing, "level the playing field" with the large money center banks and largest thrifts that can raise deposits with existing (but costly) extensive branch operations in this most difficult and competitive deregulated environment. And certainly legislation must satisfy the concerns and requirements of members of the Senate and the House since in the final analysis, it is their concerns that will shape the legislation.

We supported the section on brokered deposits in S-2851, 2nd Session, 98th Congress, authored by Senator D'Amato and Senator Mattingly as the best possible compromise based on the information then available. However, since the passage of S-2851, some enlightening facts have been compiled and published, which in our opinion is of such import and depth that we believe the section of S-2851 dealing with brokered deposits should be re-examined and amended in the light of these new facts. We feel that not only are there many reasons for a legislative solution to brokered deposits, but also the need for legislation is urgent. Soon after the regulators failed to win a legal challenge to their ill-conceived "brokered deposit rule", the FDIC and FHLBB began a well-calculated campaign designed to intimidate all banks and thrifts, including hundreds of highly regarded institutions, against the use of brokered deposits. In recent months and weeks, we have met with more than 100 officers of successful banks and thrifts who have given eloquent testimony to the pressure presently being exerted by FDIC and FSLIC field examiners against any use of brokered deposits. These banks and thrifts have turned to other sources for deposits such as their own money desks, national advertising and deposit listing services all of which have resulted in higher direct costs (from 50 to 150 basis points higher and considerable indirect costs such as staffing, paperwork and more). In several instances, these additional costs have reversed a positive net interest margin to negative net interest margin.

Without exception, these executives expressed a desire to be here with this panel to tell their story -- but would not be willing to do so for fear of reprisal from their regulators. It is for these banks and thrifts, and hundreds more and their customers, that we urge you to move legislation on brokered deposits with the utmost dispatch.

We would like you to recall the recent history before enumerating the facts we believe warrant a re-examination of an amendment to brokered deposit limitations in S-2851 and the amendments we propose. It has been said that it is necessary to understand the past in order to deal with the present.

In this context, then, it is important to remember that brokered deposits are not a new phenomena. In the early sixties, then City National Bank (now CitiBank) opened a new era in the acquisition of deposits when it began to sell jumbo CDs to investors nationwide and worldwide. While jumbo CDs had been marketed before the early sixties, it wasn't until a major Wall Street broker agreed to create a secondary market that this method of acquiring deposits became an important source of deposits. Soon after, most major money center banks and many of the regional "Top 100" followed the lead of City National. In as much as the U.S. banking system is the only one worldwide that permits the acquisition of loans through interstate offices while limiting the acquisition of deposits to intra state offices, it became apparent that this new source of deposits would increase in importance as major banks' assets grew more rapidly than in state branch-based deposits could accommodate.

In the late seventies and early eighties, many smaller, less visible, but well-managed banks and thrifts particularly in the rapidly growing Southwest and Western markets found stiff competition for loans from the major institutions. As a result, they too opened loan offices interstate resulting in a need to generate deposits in a national market place. Because of their size, they were effectively cut off from brokered deposits through the major Wall Street firms resulting in the growth of new firms to fill this vacuum.

Our firm, founded by two men with more than 25 years of (combined) experience with two major Wall Street firms, and with expertise in the capital and money markets (government and municipal securities, BAs and CDs), and a universe of small to middle market institutional clients, was established to fill the needs of those clients, some a source of funds (investors) and others as users of funds (CD issuers). Now the well-managed but less visible bank or thrift had a more "level playing field" and could compete with the larger money center institutions for loans and deposits on more or less an equal basis.

The new and more recent "phenomena" of money brokers, then, was a market driven one whose parents were a deregulated environment for assets and a vacuum of opportunities for liabilities for the smaller institution in a market dominated by large money center banks and thrifts, and the major Wall Street brokers who catered to their needs.

It is a fact that the 25 largest banks and thrifts control almost 30% of all deposit dollars. A limit on brokered deposits or even a cap on short-term deposits for well-managed, viable but smaller banks and thrifts would:

(1) Further consolidate deposits in the larger "too big to fail" banks and thrifts;

(2) Would force well-managed banks and thrifts to rely on more costly alternative sources for deposits;

(3) Reduce the flexibility of bank and thrift managers to practice asset/liability management techniques that can immunize an institution from interest rate risk in almost any rate environment;

(4) Reduce bank and thrift earnings at a time when positive spreads have narrowed to near record lows;

(5) Raise the cost to consumers for all bank and thrift services;

(6) Not prevent banks or thrifts from making bad loans or indulging in risky investments;

(7) Not eliminate fraudulent or illegal banking practices or insider dealing, and finally;

(8) Would not force regulators and examiners to act more quickly and prudently to stop these above-mentioned practices.

Are brokered deposits the cause of bank failures? In late 1983, and early 1984, Ed Gray, Chairman, FHLBB and William Isaac, Chairman, FDIC, alleged that brokered deposits were responsible for many of the problem institutions. But many banking experts plus the House of Representatives Committee on Government Operations, Cates Consulting, and even Mr. Isaac himself now says otherwise:

(1) In Time magazine, December 3, 1984, Mr. Isaac said, "Bankers got many of their current problems the old fashioned way -- they earned them. The common thread in the industry's trouble is bad management."

(2) David Cates, highly regarded bank and thrift analyst and head of Cates Consulting, quoted in the American Banker, May 29, 1985, says that, "Banks fail, quite simply because of mismanagement."

(3) Regulatory ineptness contributed to bank failures, said David Cates, "Of those banks that failed during 1981-83 period, only 37% had an adverse rating based on the last exam before failure and 34% got a clean bill of health from regulators on their last exam prior to collapse."

(4) The New York Times, November 16, 1983, states that a House Committee report on the collapse earlier this year of the Tennessee and Kentucky Banking empire controlled by the Butcher brothers criticized the staff of the FDIC for "extreme regulatory neglect" in failing to take stronger action against the bank's senior officials, and that Jake and C. H. Butcher engaged in an unrelenting series of unsafe and unsound and conceivably unlawful banking practices over six years. Alan Whitney, a spokesman for the FDIC said, "the agency would be the first to admit that we made a mistake in supervising U.A.B." (Jake Butcher has pleaded guilty to charges of fraud and is awaiting sentencing.)

(5) Edwin Gray, Chairman FHLBB, admitted during congressional hearings in April 1984 that his agency might have been able to prevent Empire's failure if it had acted faster and more decisively. Gray added in the April 30, 1984, American Banker that the failure of Empire Savings was the result of "one of the most reckless and fraudulent land investment schemes ever encountered by the FHLBB."

(6) The Wall Street Journal on July 16, 1982 quoted Fernand St. Germain, Chairman, House Banking Committee, on the closing of Penn Square Bank, ". . . hundreds of investors placed money . . . in an institution which an agency of the U.S. government knew to be unsound . . . public monies were used to examine the bank, collect data to analyze the condition, but the public didn't receive the results of the work for which they paid."

(7) Attorney General Edwin Meese III announced plans for a multi-agency attack on bank fraud, which he said had been a factor in more than half of the bank failures over recent years. Mr. Meese said that in 1984, there were 79 bank failures, and 27 failures of savings and loan institutions, a record number since the beginning of Federal controls in the 1930s. According to a Justice Department survey of 75 FDIC-insured banks that failed between 1980 and 1983, 61% involved "actual or probable criminal misconduct by bank insiders," he said.

(8) Edwin Gray in an appearance before a Senate Appropriations Subcommittee in March of 1985 said his examiners are grossly underpaid. Donald Hovde, FHLBB member, said "there is a high attrition rate among the Board's examiners. Twenty-five percent of our staff has less than two years' experience. In our Dallas office, 43% are trainees. We could use 130 examiners nationally tomorrow."

(9) Bank Board Chairman Gray has made repeated public appearances citing "horror stories" including thrifts and money brokers. However, former members of the Bank Board staff say the dozen or so "horror stories" represent an insignificant number when compared to the 3,500 thrifts in the country (and an even less significant amount when compared to the aggregate total deposits in the nation's thrifts).

Are then, the regulators' attacks on brokers and brokered deposits a smoke screen to hide their own ineptness or to mask even more serious problems in the banking system? Are brokered deposits the problem the regulators would like you to believe?

The case for brokered deposits:

(1) On September 28, 1984, House Report 98-1112, 98th Congress, 2nd Session, by the Committee on Government Operations published its findings in a 55-page booklet. Time permitting, we recommend to you reading it in its entirety. For the record, we will summarize here its findings:

"This analysis concludes that there is neither concrete evidence nor a coherent argument that insured deposit brokerage is inherently harmful to the banking system. Removal of the deposit insurance coverage for brokered deposits, as attempted by the agencies in their rule, cannot be justified by the evidence the agencies have presented, and it is also doubtful that capping every institution's holdings of brokered funds at some specific percent of deposits will have much effect.

There is clearly a problem in the deposit insurance system because of the subsidy it provides for high-risk lending strategies, and the insuring agencies have undeniably encountered cases of serious lending abuse funded with insured brokered funds. The arguments of the FDIC and FHLBB to justify removing effectively all deposit insurance coverage from brokered deposits break down, however, because of their failure to establish two key points. They have not established that the specific abuses cannot be controlled through normal supervision and, where warranted, criminal prosecution, and they have not established that eliminating insured deposit brokerage will stop the abuses.

In fact, there is persuasive evidence to the contrary on both points. On the first point, the Comptroller of the Currency has found it feasible to control the abuses among national banks within the existing regulatory framework and has consistently and publicly opposed the efforts of the FDIC and FHLBB to restrict the insurance coverage of brokered funds on the grounds that such a restriction is unnecessary. The FDIC and FHLBB have never satisfactorily explained why the normal supervisiory tools that are sufficient for the Comptroller are not sufficient for them also.

As to whether eliminating the insurance coverage for brokered funds will stop the abuses, or at least significantly hinder them, neither agency has made any attempt to demonstrate that institutions not employing brokered funds do not engage in similar abuses. Furthermore, on the basis of the agencies' own arguments about how banks and thrifts use brokered funds, the presumption would have to go the other way. Brokered funds are essentially used as a funding source for rapid growth by risk-oriented bank and thrift managers, and there is ample demonstration in the statistical materials presented in the preceding chapter that, among problem institutions, rapid growth without brokered funds is much more common than rapid growth with brokered funds. In other words, substitutes appear to be readily available for institutions that are denied access to brokered funds.

Finally, the committee rejects the agencies' notion that insured deposit brokerage is inherently an abuse of the insurance system that should be eliminated even if no abusive banking practices were associated with it. On the contrary, there are benefits to both depositors and sound financial institutions from the responsible practice of insured deposit brokerage.

For these reasons, the committee finds no justification for removing the deposit insurance coverage for brokered funds. Furthermore, for similar reasons, the committee also has reservations that putting a cap on the short-term insured brokered funds that institutions may hold at 15 percent of deposits may not contribute materially to relief from the abuses that have been associated with brokered funds.

The committee is concerned, finally, about the anticompetitive aspect of the agencies' efforts to eliminate insured deposit brokerage. The major stock brokerage firms' placements of their customers' funds into insured CDs, which account for a substantial percentage of the insured brokered funds in banks and thrifts, represents an innovative development in deposit gathering that contributes to the efficiency of the financial system. It also represents new competition, however, from outside the traditional boundaries of the banking and thrift industries. Therefore the agencies' effort to eliminate insured deposit brokerage, if successful, would have stifled this competition. Suppression of constructive innovation and competition is never good regulatory policy, and regulatory steps that have this effect should always be avoided unless other compelling factors make it necessary to override the competitive considerations. In the brokered funds situation, such compelling factors were not established by the agencies."

(2) On April 25, 1985, the House Committee on Commerce, Consumer and Monetary Affairs, concluded in a new report that it sees little evidence of abuse to support the FDIC claim that use of brokered deposits by commercial banks should be severely restrained.

While the FDIC announced that troubled banks used more than $9.3 billion of the $24.3 billion in brokered deposits in the banking industry, the subcommittee said this figure "has no relevance as an indicator of the size of the brokered funds problem". The subcommittee said that $8 billion of the more than $9 billion referred to by the FDIC was held by 13 or 14 large national banks "whose 'troubled' classification had nothing to do with their reliance on brokered funding." In addition, "most of this $8 billion in brokered funds was uninsured, anyway." (Even if we accept the FDIC figure of $9.3 billion as an accurate measure, this figure represents roughly .00465% of total deposits in the commercial banking system, hardly a significant amount.)

The subcommittee also found that brokered funding is less of a factor in bank failures than it had been previously. Failures of banks having 5 percent or more brokered funding declined from 56 percent of all failures in 1983 to 23 percent of all failures in the last half of 1984, the subcommittee said, and preliminary data for 1985 suggests the decline is still underway.

"For these reasons, there appears to be no current need for the kind of severely restrictive regulation or legislation on brokered funds that the FDIC proposed in 1984 and has continued to advocate in the current session of Congress," the subcommittee report claims.

Regarding use of brokered deposits by thrifts, information submitted by the FHLBB shows that brokered funds growth among problem institutions previously examined by the subcommittee completely stopped after March 31, 1984, and for all problem institutions rated 4 or 5 by March 31, declined at a 20 percent annual rate, even though brokered funds in nonproblem institutions grew at an 84 percent rate in the same time period.

The FHLBB March 26, 1984 imposed a temporary rule limiting the brokered funds growth of low net worth institutions.

"This appears to confirm the earlier judgment of the subcommittee that the regulators can control excessive brokered funding growth by problem institutions through supervisory means alone, without harsh new regulations or legislation," the subcommittee said.

However, the subcommittee also said the FHLBB has not effectively enforced its limit on acceptance of brokered funds by problem institutions. The subcommittee found that about 17 percent of problem thrifts were not in compliance with the rule during the second quarter of 1984, and about 21 percent were not in compliance in the third quarter.

"It therefore appears that even better supervisory control over brokered funds usage, at least among institutions with impaired net worth, can be obtained simply through consistent enforcement of the existing rule," the subcommittee said.

The FHLBB also failed to find "any fundamental systemic differences" in problem thrifts that relied upon brokered funds for their growth and those that did not, except in instances of linked financing arrangements, where funds obtained through brokers were directed toward specific, often risky, investments by a thrift, according to the subcommittee report. The agency also reported no evidence that thrifts using brokered funds paid more for their funding that comparably situated institutions paid for nonbrokered funds, the report says.

Finally, the subcommittee said that new net worth rules adopted by the FHLBB March 21, 1985, "will seriously limit the ability of institutions to continue the rapid growth policies they have followed in the past." The subcommittee said Congress should wait until it has a chance to assess the impact of these rules before considering legislation on brokered deposits.

On a separate issue, the subcommittee report also challenged the results of a research study conducted by the New York Federal Reserve Bank, which concluded that there is a need for a cap on brokered funds accepted by any individual institution. The subcommittee said the study "does not provide meaningful evidence to support a need for further brokered funds regulation or legislation."

(3) Sanford Rose, Editor of the American Banker, recently cited a study released by Cates Consulting of New York. In his column on February 26, 1985, Mr. Rose stated that, "Many would curtail or even ban the brokered deposit, which is said to have contributed to the failure of countless financial institutions. The palpable falsity of this proposition is demonstrated in a recently released study by Cates Consulting Analysts of New York. The study examines the reasons for failure at the 60 commercial banks

and some 16 savings and loans that folded between January 1 and September 30, 1984.* Particular attention is paid to the role of "brokered deposits in these 76 failures."

The study by Cates reveals:

"Of the 60 commercial banks that failed in the first nine months of last year, 37 (63%) had no brokered deposits whatsoever. Of the 23 that used brokered-funds, nine employed them so sparingly that they could not have played any measurable part in the collapse of these institutions. The median ratio of brokered money to total deposits at these banks amounted to less than 7%.

"Six failed banks made moderate use of brokered funds -- 20% or less of total deposits. Only eight banks -- 13% of those that went belly-up during the period -- might well be described as immoderate gatherers of brokered funds, with usage amounting to more than 20% of total deposits. And only two of these eight banks were brokered funds hogs, taking more than 37% of their total deposits out of the brokered-funds market.

"There were 17 failures of savings and loans from January 1 to September 30 of last year. Data are available on 16 of these unfortunate institutions. Ten of the S&Ls had no brokered deposits at all. Of the six that used brokered funds, two got less than 2% of their total deposits from brokers, one obtained 19% of its money in this form, and in only three cases was the ratio of brokered to total deposits greater than 20%."

Mr. Rose has gone on to provide us with the following observations:

The most significant datum in the Cates study concerns the ratio of brokered funds to all forms of purchased money. The brokered deposit, whether retail or wholesale, bears some of the characteristics of purchased money. Brokers of retail funds generally aggregate retail deposits and place the funds in institutions in units of $100,000. Those who deal in wholesale funds perform the reverse operation, disaggregating larger chunks of money and also placing them in units of $100,000. Thus nearly all forms of brokered money appear on balance sheets in the category of large liabilities -- $100,000-and-over deposits.

---

* There were 79 bank failures in 1984, the highest number since the Depression. These 79 banks represented approximately 1/2 of 1% of all commercial banks. These 79 banks had in the aggregate $2.9 billion in deposits representing less than .0002 of all deposits in commercial banks.

"As the Cates study points out, brokered funds represent only one category of large liabilities. Jumbo CDs, fed funds, repos, and commercial paper constitute the bulk of other types of purchased money.

"Observes Ray Garea, an executive vice president of the Cates Group and the author of the study: 'If we find that significant levels of brokered deposits were present in a substantial number of 1984 bank failures, that does not necessarily support a conclusion that brokered deposits cause or were even related to such failures. If the banks that failed made excessive use of other types of purchased money, it would be inappropriate to focus on brokered funds alone as a cause of failure. Attempting to limit or eliminate the use of brokered deposits would have little effect if banks could merely shift to other forms of purchased money.'

"A glance at the Cates data reveals that this is precisely what would happen. Surprisingly, failed banks that used brokered deposits have had abundant access to other bought money. The ratio of brokered deposits to bought money at the 23 failed banks that tapped the brokered-funds market was only 37%. In other words, the users of brokered money were able to obtain 63% of their purchased-money requirements from nonbrokered sources -- ostensibly from unwary investors in their local markets.

"Looked at from another vantage, the 23 failed banks with brokered deposits were excess users of bought money. They funded nearly 40% of earning assets with large liabilities. But only 13% of their assets were funded with the brokered-deposit component of bought money. The rest of the cash came from directly place paper. Thus the evidence would seem to indicate that, absent brokered funds, these banks could have gone elsewhere to finance their shaky portfolios.

"The same point can be made about the six failed S&Ls that made use of brokers. The ratio of brokered deposits to purchased funds at these institutions amounted to 48%. Clearly, thrift users of brokered money were able to obtain more than half of their total requirements from other sources.

"Where did these six as well as the other 10 failed thrifts get the purchased money that financed an excessive portion of their earning assets? That's easy. They got a large chunk of it from their respective Federal Home Loan Banks. Purchased funds at the 16 failed thrifts financed around 30% of earning assets. The proportion of earning assets funded by FHLB advances at these institutions averaged nearly 14%.

"Failed thrifts made considerably greater use of FHLB money than did healthier associations. The question might then be legitimately asked: If the regulators themselves provided the wherewithal for shaky associations to greatly expand their operations, how is it possible to single out for condemnation the deposit broker, who in some cases merely supplemented the effort of the governmental authorities?

"Or as analyst Ray Garea puts it more piquantly: 'If one wants to argue that a specific liability category causes S&L failures, then the solution is to dismantle the Federal Home Loan Bank System!'

"But the obvious fact is that specific liability categories are not responsible for the demise of thrifts or for that of commercial banks either. The 16 savings and loan casualties of 1984 perished because they assumed even more interest rate risk than did their peers. As a result, their net interest margins and their book capital positions deteriorated more rapidly than was the case at those associations which still cling to life.

"The 60 commercial banks that failed in 1984 did so because of problems of asset quality. In 1983, the median ratio of nonperforming loans to total loans at these 60 institutions was an astounding 11.44%. The ratio of chargeoffs to loans in 1983 was approximately 10 times greater in these banks than it was for banks in general. Even in 1982, 40% of the 1984 failures had loan losses equal to or greater than 1.46% of total loans." (Separately, an item in the American Banker, March 12, 1985, states that the FHLB propped up $110.6 million asset Western Community S&L with $106 million in loans during the 12 months preceding the closing of the thrift due to insolvency.)

(4) The Morgan Guarantee survey of January 1984 concludes: "The activities of money brokers are only a symptom of the underlying problem -- the encouragement of risk-taking provoked by the current system of deposit insurance. Even if brokered deposits were banned altogether, depository institutions could continue to obtain funds by other means, such as more widespread advertising. In fact, in the absence of money brokers, the establishment of a national newsletter to provide information to depositors on where they could obtain the highest rates would be a likely development. Depositors could then transfer funds in $100,000 increments to different depository institutions and continue to obtain federal deposit insurance for all these funds."

(5) Governor Gramley of the Federal Reserve, Mr. Wallison of the Treasury, former Comptroller of the Currency Conover and former FHLBB Chairman Pratt, cited various benefits to consumers, the financial institutions, and the economy from deposit brokerage.*

(6) On March 4, 1984, former Comptroller T. C. Conover was quoted in the Los Angeles Times: "While it is true that brokered funds may help problem banks grow quickly, it is important to remember that the problem is how the funds are used and not where they come from. Federal and state regulators have adequate authority and have had considerable success in dealing with the occasional mismanagement of assets by poorly managed institutions. I see no reason to believe that they will not be able to continue this performance in an era of brokered deposits."

(7) John Kareken and John Danforth, Sr., associates of Golembe Associates, Inc., a consulting firm, say: "Deposit brokers conserve on the resources devoted to deposit gathering and promote the movement of funds to their highest-value uses. If effective, uninsuring brokered deposits would thus be economically inefficient, and in addition would divert deposits away from small and medium-sized depository institutions and into the nation's largest. Moreover, it is extremely doubtful that adoption of the proposed new regulations would serve as an effective deterrent to institutions intent upon abusing the deposit insurance system."

(8) Former Senator Tower says that "Brokered CDs utilized by S&Ls have proven to be an important source of lending for residential housing." The Senator also said the funds were of "critical importance" to institutions trying to match assets and liabilities and trying to "respond efficiently" to the present deregulatory and competitive environment.

(9) And, finally, in his testimony on October 27, 1983, before a House Subcommittee, FDIC Chairman William Isaac said, "Many money brokers have performed responsibly. The benefits they have provided to both financial institutions and investors need only to be highlighted here. A financial institution that uses a broker's services to market its CDs can realize important cost savings through reduced staffing and paperwork requirement. Another advantage is that the institutions gains flexibility with respect to the amount and maturities of the CD it issues. This flexibility in turn can enable an institution to better match its assets and liabilities. Most important perhaps, is the access to national money markets that a broker can provide, particularly

* Page 7, House of Representatives Report, 98-1112.

for small and medium-sized financial institutions. Money brokers also provide obvious benefits to investors."

By now, any open-minded reader of the foregoing, including the severest critic of deposit brokerage, must agree that: (1) brokered deposits provide a valuable and useful tool for investors and issuers alike; (2) bank mismanagement, including fraud and insider dealing is a major cause for bank failures; and (3) a more alert, responsible regulatory effort can prevent most failures before they become major problems within the currently existing regulations.

We agree, however, that there remains legitimate concerns of the FHLBB and FDIC that must be addressed in appropriate legislation. These concerns were summed up by Chairman Gray of the FHLBB and reported on January 17, 1984, in the American Banker: "The issue we take up today on the appropriateness of an unregulated financial entity collecting funds, charging a sizeable fee, the placing of the funds without regard to the safety and soundness of a recipient depository institution and without regard to the potential consequences for the federal deposit insurance funds."

We, therefore, would like to have this Committee consider the following suggestions for inclusion in a bill on brokered deposits, or as amendments to S-2851. We are confident that they realistically meet and even exceed the stated concerns of the regulators:

1. Register all brokers with the N.A.S.D. (for more than 50 years, the NASD has been an effective regulatory body with a long and distinguished history in the regulation of the securities industry).

2. Require all brokers of certificates of deposit to deal only with commercial banks and thrifts which meet or exceed regulatory minimum standards. (Brokers would be required to do a financial analysis of the institutions they perform a deposit brokerage service for, at least semi-annually. This analysis can be done "in-house" or purchased from one of several outside firms. Additional financial disclosure as called for by Chairman Isaac of the FDIC (but not endorsed by Chairman Gray) and more timely reporting would be helpful, but not completely necessary.

3. Require all deposit brokerage firms to report quarterly, to the appropriate agencies, the name of each institution for whom they provide service and the amount of dollars brokered during the preceding quarter.

4. Require all deposit broker firms to refrain from providing service to any institution which does not meet regulatory minimums without written permission from the appropriate agency. (This will meet those special circumstances such as American Savings where the regulators asked a group of firms to raise $1 billion in deposits.)

5. The provision in S-2851 calling for "caps" in brokered deposits should be removed since the concerns of the regulators are met by our other proposals.

6. Brokers should be required to provide their client depositors with financial information on the financial strength and performance of the institutions receiving funds.

7. Institutions should be required to disclose information on their loan portfolios including a general description of the types of loans, percentage of loans in each area to indicate institution's position in an area and a disclosure on non-performing loans in each category.

Mr. Chairman, thank you for this opportunity to address the committee.

William Goldsmith
Executive Vice President
Professional Asset Securities, Inc.

Senator **Gorton**. Thank you, Mr. Goldsmith.

Mr. Falzon, I will start with you, if I may. How true is it that long-term brokered deposits won't flee troubled institutions at the first sign of trouble?

APPROXIMATELY 100 FAILURES IN 1984

Mr. **Falzon**. We have always drawn a distinction between long- and short-term deposits. For instance, if you look at the failures during 1984, I believe there were approximately 100 failures in thrifts and commercial banks. Those that used a high percentage of brokered deposits got into trouble with short-term deposits; virtually none of those 100 institutions were in trouble based on using longer term brokered deposits.

Senator **Gorton**. If they are all insured, what difference does it make?

Mr. **Falzon**. Well, there are a couple of reasons it makes a difference. One, the use of long-term deposits eliminates the potential for abuse in terms of mismatching assets and liabilities. A lot of institutions got into trouble, specifically the thrifts over the last couple of years with the volatility of interest rates, borrowing short and lending long. It works in a declining interest period like now, but we all know too well that that reverses itself. By matching assets and liabilities over the longer term there are more benefits.

Also, by using long-term deposits institutions are not subject to as much disruption in their funding flows or subject to illiquidity should they have problems rolling over these deposits because they have the deposits for a much longer period of time, and as a result they've got an opportunity to work out any problems.

Senator **Gorton**. How reliable is the pledge you've expressed to us that Merrill Lynch will repurchase CD's? Is that a temporary business decision? Is this a permanent matter to which you are fully committed?

Mr. **Falzon**. We are fully committed to provide an ongoing secondary market to our customers. Although we can't guarantee this and we wouldn't guarantee the obligation's creditworthiness of any issuer, we have always provided liquidity, even in institutions that have had problems or where there were temporary liquidity problems in the insured and uninsured markets. Take FNB Midland, for instance. We provided secondary market making capabilities and liquidity to our investors right up until the time the merger was successfully completed.

We have in our own inventory positions usually amounting to several millions of dollars of each issuer's CD's. So we will own $2 to $3 million of an issuer's CD's in our inventory. Sometimes we will own as much as 50 million dollars' worth. Even though we have heard that we are not at any risk, we are at substantial risk.

But more important than that is our relationship with all of our individual clients. They have come to respect Merrill Lynch, look to us to provide that kind of service, and that is one of the reasons why they buy a retail CD for a longer term. They look for that long-term liquidity as a substitute investment, perhaps for a Federal agency security or purchasing a U.S. Treasury bond.

Senator **Gorton**. Ms. Kelsey, does Dean Witter stand ready to repurchase the CD's as Merrill Lynch does?

Ms. **Kelsey**. Generally speaking, I would echo Mr. Falzon's comments about the Dean Witter commitment to secondary marketing of CD's.

Senator **Gorton**. Is that a common practice among brokers?

Ms. **Kelsey**. Among the major brokers, yes.

Senator **Gorton**. Back to you Mr. Falzon and another approach to one of my questions. Even if long-term funds don't flee and short-term funds do, is that really relevant to the problem we have here in this committee? The insurance fund's liability is just as painful if a bank fails with long-term deposits as it does with an excess of short-term deposits, isn't it?

Mr. **Falzon**. But if we look at the record, at the abuses that have happened and where the failures have been with short-term deposits and issuers trying to take short-term deposits and then trying to achieve the highest possible return on an investment on the other side, that has been where the problems have been.

Senator **Gorton**. Is it your position that most bank failures are those where the bank has a large percentage of the short-term deposits?

Mr. **Falzon**. The evidence that we have, again during 1984 specifically—we haven't researched it longer than that, but I suspect it will probably go back further than that—is that all instances where there was a high use of brokered deposits it was due to high short-term brokered deposits and not longer term.

Senator **Gorton**. Are we seeing such an increased degree of sophistication on the part of brokers that within a foreseeable period of time for all practical purposes the entire market will be insured?

Mr. **Falzon**. No; on the contrary, what was mentioned earlier was that of the $9 billion in the three, four, and five banks Chairman Isaac felt that most of it was insured. The Barnard Committee contradicted that statement. A very small amount, a modest amount of that $9 billion was actually insured.

Mr. **Goldsmith**. $1 billion of the $9 billion.

Mr. **Falzon**. We have found in fact that our outstanding insured CD's have leveled off over the past year or 1½ years. So we certainly haven't experienced, the exponential or skyrocketing growth that was predicted sometime ago in brokered deposits. Our insured deposits have leveled off.

ANALYSIS ON POTENTIAL CD ISSUERS

Senator **Gorton**. Ms. Kelsey, you state that Dean Witter performs an analysis on potential CD issuers comparable to that which you would do if you were going to extend a loan. What is the reason or the rationale for that effort if the CD is fully insured?

Ms. **Kelsey**. There are two basic reasons that Dean Witter does an analysis. One is that Dean Witter is concerned about its ongoing relationship with the client. Generally, the customers Dean Witter sells CD's to are clients of the firm and Dean Witter does not want any disruption in its reputation with the client in its relationship with the client.

Second, Dean Witter does provide a secondary market and consequently, at some point in time Dean Witter has a position in the CD's and therefore is concerned about the creditworthiness of that institution.

Senator GORTON. Mr. Coloma, Mr. Goldsmith, do your institutions have any comparable credit analysis or any comparable secondary market?

Mr. GOLDSMITH. Mr. Chairman, we have been analyzing institutions since we went into business. I was with Merrill Lynch for almost 8 years, with Prudential Bache, then Bache Halsey, for about 4 before going into my own business in the last 4. In spite of the fact that it's our opinion that we need more disclosure from the financial institutions and more timely reporting, our analyses over the past more than 4 years have allowed us to be in only one institution at the time it failed in the most difficult 4-year period since the depression. We have an early warning system that has allowed us to stop sending brokered deposits to any institution when we see that it is experiencing some problems.

Senator GORTON. Mr. Coloma.

Mr. COLOMA. Mr. Chairman, we do make an analysis of each institution in which FAIC Securities invests its clients' funds. We have a credit department within the company. However, as a matter of policy our company does not recommend our investors invest more than $100,000 per institution. It is absolutely impossible for our company to look beyond the financial statement of each of the 750 banks and savings and loan institutions that we deal with throughout the country and make a thorough analysis of the quality of the assets of that institution.

We have had many occasions, where you have financial institutions that have their financial statements audited by an accounting firm and 3 months later they are closed by the FDIC, and then we find out they have been in trouble for the last 3 to 5 years.

So there is absolutely no way that you are going to be able to analyze the quality of the investments and loans that the managers of those institutions are making.

I hope that answers your question.

Senator GORTON. Ms. Kelsey, what proportion of Sears Savings Bank's brokered deposits are placed by Dean Witter?

Ms. KELSEY. Within the last couple of months, Dean Witter has begun placing some of Sears Savings Banks' insured CD's through other selected dealers. A number of different brokers place uninsured deposits at Sears Savings Bank.

Senator GORTON. Senator Proxmire.

Senator PROXMIRE. Thank you, Mr. Chairman.

Mr. Falzon, I'm going to follow up on one of the questions that the chairman asked at the beginning of his inquiry. Chairman Isaac testified that there is no difference between short- and long-term brokered deposits with respect to the risk to the FDIC insurance fund. He says they are the same. Why are you so adamant in opposing limits on longer term brokered deposits with maturities of more than 1 year?

Mr. FALZON. As I understand it, the FDIC is concerned about failures of their depository institutions which could result in payouts. In 1984 there were approximately 100 failures of depository institutions. A percentage of those used brokered deposits. But all of the institutions that failed that used brokered deposits used short-term volatile brokered deposits; virtually none of the 100 institutions that failed used medium term or longer term deposits.

So when you actually look at the facts, they don't support the FDIC's contention that there is no difference between short and long term. If they are concerned about failures, virtually all of the institutions that failed in 1984 that used brokered deposits only had short-term deposits. We think providing a cap short term and not having a cap long term will go a long way to solving the problem.

Senator PROXMIRE. If there is a limitation on short term, won't there be a shift into long term?

Mr. FALZON. There wouldn't be a shift into long term.

Senator PROXMIRE. Why not?

Mr. FALZON. In order to sell a long-term deposit of the kind that Dean Witter, Prudential Bache, and ourselves sell you have to provide liquidity or have your investors that buy these CD's feel that they have liquidity in the market.

Senator PROXMIRE. Let me just interrupt for a minute. They could shift to 1 year and 1 day, and then they would be long term.

Mr. FALZON. But an investor is not going to buy a 1 year and 1 day CD if they don't have liquidity. The $100,000 market, that market that represents institutional investors, deposit spreading among institutions, they won't buy 1 year CD's because they don't have liquidity. Typically the deposits that they place with these institutions are 30, 60, probably at most 90 days. But investors who buy 1-, 3-, 5-year CD's, they're not going to put their money in illiquid investments unless they are putting it in long-term IRA or Keogh accounts. We have a turnover of approximately $20 million a day in volume in secondary trading. We have anywhere between 500 and 1,000 investors daily buying and selling their CD's in the secondary market. So you cannot shift short-term to long-term unless you provide the secondary market.

Senator PROXMIRE. What percentage of your brokered deposits business comes from longer term brokered deposits with maturities of longer than 1 year?

EIGHTY PERCENT ARE LONG TERM

Mr. FALZON. I believe 80 percent are 1 year or more.

Senator PROXMIRE. Eighty percent are longer term and 20 percent are short term. So Merrill Lynch would be 80 percent unregulated; is that right?

Mr. FALZON. Well, we would be unregulated as far as caps go, but there are other features in the Senate bill that we support in terms of being regulated and not allowing weak institutions to access the market, which are important to us as well.

Senator PROXMIRE. Ms. Kelsey, you say on page 2 of your testimony:

> It is important to note that those institutions which have failed, and have had a high percentage of brokered funds, have failed not because of the way funds were gathered, but rather the way the institutions were managed.

Isn't it true, however, that brokered funds have helped problem banks grow quickly, as was dramatized by some of the material given to us by the two regulators, and thus contribute to the management problems in those banks? Why should the FDIC in effect be subsidizing such problem banks in obtaining funds?

Ms. KELSEY. I think the question is the decisionmaking order on raising deposits through brokers and how the institution is going to invest the deposits. Generally speaking, I would say that management that is set on a course of investment looks around for funds to support that investment. They've embarked on a speculative investment scheme, perhaps in even some cases it's fraudulent. They've made that management decision. It's not the fact that they can raise brokered funds that has caused them to decide to make those speculative investments.

Senator PROXMIRE. There is a connection, though. The *Empire* case, which was dramatized by Mr. Gray. That was a case in which these people got a 1,600-percent increase in 2 years in their deposits, brokered funds. Now when they grow that fast, can't you say that the enormously increased growth had something to do with it? We find up here on the Hill when we fund an agency like the Defense Department, increase their funding 10 or 15 percent a year, they get in a lot of trouble if you go too fast with it. This is a 1,600-percent increase in 2 years. Wouldn't you expect an institution like that to get over its head because the brokered deposits come in such an abundance?

Ms. KELSEY. I would expect the regulatory agencies to have been on that institution prior to its failure. To have watched a growth rate like that, and apparently not to have stepped in to do something about it, is quite incredible to me.

Senator PROXMIRE. As we pointed out, they have a lot of institutions to regulate and they can only examine these institutions once a year or once every 2 years. So it's not that easy.

Mr. Coloma, you make the same point on page 5 of your testimony, that is that the risk to the FDIC fund is not caused by brokered deposits per se, but by the handiwork, "of incompetent or unscrupulous managers who have gambled away, insured deposits on high-risk investments or outright fraud."

Mr. COLOMA. Yes, sir.

Senator PROXMIRE. My concern and that of the regulators is that brokered deposits are like manna from heaven to such incompetent and unscrupulous managers. In other words, if you give people who have that level of competence or integrity that much, then you can expect that end result, can't you?

Mr. COLOMA. How am I to judge what their motives are? If a financial institution approaches our company for some deposits, we make our analysis of the financial condition of the institution.

Senator PROXMIRE. Mr. Coloma, we are not asking you to make that judgment; we're just trying to put limits on the amount of funds that would flow in.

Mr. COLOMA. Yes.

Senator PROXMIRE. What is wrong with that?

Mr. COLOMA. I have no problem with that. I have proposed a 20-percent cap on insured brokered deposits on all financial institutions regardless of the maturity of the deposit.

Senator **Proxmire**. Why do you favor that?

Mr. **Coloma**. I have done that in the spirit of cooperation between our industry and the regulators, because even though we have been able to win in the courts they still are trying to regulate the deposit brokerage business out of existence.

Senator **Proxmire**. I think that is good and I commend you for it, and I think that is in keeping with the philosophy expressed by Mr. Isaac and Mr. Gray.

Why do you not distinguish between long and short term?

Mr. **Coloma**. I do not make a distinction in reality. If you ask me, and I have to be honest about an answer, I must agree that there has to be a very small amount of greater concern about short-term insured deposits than in longer term insured deposits. Chairmen Isaac and Gray do not make a distinction, but I have no disagreement if short-term insured deposits are capped at a somewhat lower level than long-term insured deposits.

Senator **Proxmire**. Chairman Isaac testified that your firm has brokered funds to most of the banks that have failed. How do you account for that?

FAIC DOES 95 PERCENT OF ITS BUSINESS WITH S&L'S

Mr. **Coloma**. I think Mr. Isaac made a mistake in the name of the company. As a matter of fact, 95 percent of the business that my company does is with savings and loan, not with commercial banks. We do very, very little business with banks. I believe he made a mistake. My company has not been named publicly since the beginning of the year when the FDIC started a policy of publishing the names of brokers placing funds in banks that fail. Our company has not been involved in any one of those failures.

Senator **Proxmire**. You called for a 20-percent ceiling on brokered deposits. Do you make any distinction between short- and long-term brokered deposits? If not, why?

Mr. **Coloma**. I do not make any distinction between short- and long-term insured deposits. In order to accommodate the regulators who are trying not to make a distinction between long- and short-term insured deposits, I have supported their policy and their position.

Senator **Proxmire**. Ms. Kelsey, in your statement on page 2 you say:

> As of the end of May, uninsured deposit accounts represent some 27 percent of Sears Savings Bank's total deposit base; insured brokered deposits on the other hand represent 16.8 percent of Sears Savings Bank's total deposit base.

Clearly Sears is doing well with the uninsured aspect of its brokered deposits and finds that a profitable aspect of the business. If that's the case, why should brokered deposits be insured at all?

Ms. **Kelsey**. I'm sorry, I didn't fully understand the question.

Senator **Proxmire**. Why should brokered deposits be insured at all?

Ms. **Kelsey**. We have found that, as you pointed out, the uninsured accounts represent a significant amount of our funding. Part of that reason is because it is Sears Savings Bank and it is considered a good credit risk by large depositors. The uninsured accounts are accounts of $1 million and more, and so they are a flexible source of funding for the institution. The insured brokered accounts, on the other hand, represent an alternative delivery system for Sears Savings Bank. They are a means of tapping an additional customer base; the Dean Witter customer base. They provide, generally speaking, an ability to raise longer term funds from that customer base as opposed to our own retail customer base.

Senator **PROXMIRE**. It seems well-managed banks can attract brokered deposits without the crutch of insurance. You see, what bothers me, and I suspect maybe it bothers others, is the fact that it is kind of a very attractive situation for those selling brokered deposits to take advantage of the fact that there is insurance. The regulators have come in this morning and protested very, very strongly, as strong as I have ever heard regulators protest, that they are being unfairly undermined and their funds are being stripped by this process of just shoving these deposits into institutions under these circumstances. You don't have to worry about the management because they are insured.

Ms. **KELSEY**. I think what we are talking about may be broader than the issue of brokered deposits. It's a question of the Federal Deposit Insurance System and the fact that, because of level premiums, it tends to encourage the risk takers. If the risk takers pay the same premium as the more conservative institutions, there is a disincentive involved in the insurance system. There have been significant changes caused by economic changes, technology and consumer demands, which have pushed the financial institutions toward system deregulation and restructuring. Yet, we have the same deposit insurance system we have had for 50 years. I think we have come to the point where there is a real tension between the way institutions are operating and the system which is used to regulate them. I think we have to address that issue.

Senator **PROXMIRE**. I would like each of you to tell me, if you can, off the top of your head if not for the record, how many of the failed banks and thrifts that failed last year had deposits brokered by your firms?

Can you do that off the top of your head, Mr. Goldsmith?

Mr. **GOLDSMITH**. Yes, I can. Are you talking about at the time of failure were we brokering deposits into these banks and thrifts?

Senator **PROXMIRE**. Anytime during the year.

Mr. **GOLDSMITH**. Oh, yes. There were a couple of institutions where we had been brokering deposits but stopped when we saw that the institution was not performing as it did when we first analyzed it.

Senator **PROXMIRE**. For the record, will you give us the data on that?

Senator **GORTON**. Didn't you say that there was one?

Mr. **GOLDSMITH**. There was only one bank, and that includes S&L's, since 1982 that we were actively brokering deposits at the time it failed.

Senator, may I add something?

Senator **PROXMIRE**. Sure.

MARKETS MOVE IN TWO DIRECTIONS

Mr. **Goldsmith**. Mr. Falzon and Mr. Isaac seem to forget that markets move in two directions, up and down. We are of the opinion that brokered deposits are not the cause of the problem banks; we are of the opinion that there should be no caps but that other means can be taken to solve the problem. Institutions that have been accepting short funding over the last 6, 7, 8 months are far better off today than institutions that have been taking long funds, because the market for CD's and other money market and capital market instruments have been going down; that is, interest rates have been going down. So those that have turned their deposits more frequently would certainly be in a better competitive position today than those locked in high rates.

Senator **Proxmire**. Thank you.

Mr. Falzon.

Mr. **Falzon**. I'm glad you asked that question. Earlier this morning Chairman Isaac mentioned two occasions where Merrill Lynch, he thought, placed brokered deposits in failed institutions. First of all, the one bank in Puerto Rico, we had absolutely no brokered deposits in that bank. A subsidiary of Merrill Lynch's placed funds with that bank, but it was on an unsecured basis and it did not represent brokered deposits. So that statement was a clear misrepresentation of the facts.

The second situation, FNB Midland, I would like to explain. We had a relationship going back to 1980 with FNB Midland. At that time that bank was evaluated by major rating services across the country to be one of the strongest capitalized banks of its size. The bank, in fact, was rated a B by Keefe Bruyette, an astute, very well recognized rating service. In addition to being well capitalized and serving its local community in energy lending, the owners and the people who ran the bank were probably some of the wealthiest men in the country, certainly some of the most respected people in their region in Texas. At that time in 1980 we sold uninsured CD's for them in addition to insured CD's. After a while when energy lending resulted in losses for banks, particularly in the Southwest, and our credit department saw that their situation was deteriorating, we withdrew our support from the bank on a slow, gradual basis. In the first quarter of 1983, when the fourth quarter of 1982's results were in, we realized that the bank's situation was deteriorating very quickly, and at that time we stopped selling brokered CD's for the bank. But that bank did not fail.

So to answer your question, Merrill Lynch has never placed any deposits with any failed institution, because we didn't place any brokered deposits with the Puerto Rico bank and the Midland situation was a successful merger.

Senator **Proxmire**. Mr. Coloma.

Mr. **Coloma**. Would you ask the question again, please?

Senator **Proxmire**. The question is, how many of the failed banks and thrifts that failed last year had deposits brokered by your firm at any time during the year.

Mr. **Coloma**. I am not sure, but would be glad to respond for the record.

Senator **Proxmire**. For the record, would you tell us who they are. I'm not asking you to do that now, but for the record.

Mr. **Coloma**. Yes, sir.

[The following information was subsequently supplied for the record:]

LAW OFFICES OF
BRUCE JOHNSON

Avenue of the Arts Building
Broad & Chestnut Streets
Suite 1009
Philadelphia, Pennsylvania 19107
(215) 735-7840

1718 Connecticut Avenue, N.W.
Suite 310
Washington, D.C. 20009
(202) 939-8391

September 18, 1985

To: Senate Committee on Banking, Housing and Urban Affairs

From: Bruce Johnson

Re: Brokered Funds Placed BY FAIC Securities In Closed Banks

The following list was prepared in response to your query regarding the dollar volume of brokered deposits placed in closed banks by FAIC Securities, Miami, Florida. Also, included are the percentage of the bank's total deposits and brokered deposits that these funds represent.

DATE CLOSED	BANK NAME/ADDRESS	DOLLARS	% OF BANK'S DEPOSITS TOTAL	BROKERED
4-12-85	South Coast Bank Costa Mesa, California	1,400,000	5.2	56.0
12-20-84	The Farmers State Bank Seldon, Kansas	(a)	(b)	(b)
6-18-84	Republic Bank of Kansas City Kansas City, Missouri	3,000,000	7.6	16.7
6-1-84	Garden Grove Community Bank Garden Grove, California	4,269,000	11.6	23.1
5-18-84	Bank of Irvine Irvine, California	100,000	(c)	7.1
5-11-84	First Continental Bank and Trust Company Del City, Oklahoma	3,614,000	3.7	16.8
5-8-84	The National Bank of Carmel Carmel, California	100,000	(c)	(c)

DATE CLOSED	BANK NAME/ADDRESS	DOLLARS	% OF BANK'S DEPOSITS TOTAL	BROKERED
4-27-84	West Coast Bank Los Angeles (Encino), California	14,294,000	8.9	17.0
4-6-84	Watauta Valley Bank Elizabethton, Tennessee	688,000	5.1	36.4
3-16-84	Seminole State National Bank Seminole, Texas	300,000	(c)	100.0
3-16-84	Heritage Bank Anaheim, California	10,903,000	7.1	11.1
3-2-84	All American National Bank Virginia Gardens (Miami), Florida	2,000,000	17.5	100.0
4-3-82	Aquia Bank & Trust Company Stratford, Virginia	3,636,000	29.4	100.0

In some instances the dollar volume of brokered funds is taken from records reflecting balances several business days before the actual closing.

(a) Dollar volume figure for FAIC not available (estimated to be $400,000 or less).
(b) Estimated to be less than five percent of total deposits and less than 15 percent of brokered deposits.
(c) Less than one percent.

Ms. Kelsey. Dean Witter had no funds in banks or S&L's that failed last year.

Senator Proxmire. Thank you.

Thank you, Mr. Chairman.

Senator Gorton. Senator Dodd.

Senator Dodd. Mr. Chairman, I don't have any questions. It would be highly inappropriate, just walking in. I do want to apologize to you and my staff. They did a lot of work in preparation for today and unfortunately I had a hearing that went about 3 hours and I didn't get a chance to get down. I apologize to all of you.

I would like to submit some questions, if I could.

Senator Gorton. We will be happy to have you do so.

Mr. Goldsmith and Mr. Coloma, what share of your business is with individuals as opposed to institutions?

Mr. Coloma. With institutions as compared to individuals?

Senator Gorton. Yes.

Mr. Coloma. I would say probably 95 percent of our business is done with institutions.

Mr. Goldsmith. Mr. Chairman, I would say that about 85 to 90 percent of our business is with institutions.

I would like to for the record answer a question that was put to Ms. Kelsey a few moments ago by Senator Proxmire. One of the questions that he posed was could we do without insurance.

Senator Gorton. Excuse me. That was my next question. You can incorporate that and answer it with Senator Proxmire's.

Why should institutions which generally speaking are quite sophisticated be eligible for Federal deposit insurance in any event?

Mr. Goldsmith. First of all, the assumption that institutions are sophisticated—I hate to correct the honorable chairman.

Senator Gorton. That's all right.

Mr. Goldsmith. The assumption that institutions are sophisticated is faulty by a wide margin as evidenced by the recent failures of ESM and Bevil Bressler [phonetic] and the institutions that had investments with them were the same institutions that had investments with brokers that failed in 1982 for the same reason. They are not sophisticated.

However, having said that, we can live without insurance. We don't need insurance. If the insurance system was established to protect the integrity of the banking system, as it was, the average investor today has probably—and I'm guessing at this—in the neighborhood of maybe less than $20,000 in deposits. I would suggest that Congress in its infinite wisdom reduce the insurance on deposits from $100,000 back to the $40,000 or $20,000 level we had years ago. I realize that may be politically unpopular. But I say we could live without insurance if we could unlock the doors of secrecy that surround banks and thrifts financial information. If we had adequate financial information, we could do a better job than the FDIC and the FHLB have done. With all of their information they haven't been able to detect banks and thrifts failure, but we have been able to in pretty good order with less information than they had.

Yes, we could get along without insurance providing we had the adequate financial information.

Senator GORTON. Mr. Coloma.

Mr. COLOMA. My company could not live without an insurance system, Mr. Chairman.

Mr. GOLDSMITH. I might add to that. Prior to July 5, 1982, 80 percent of all of our deposits were uninsured. On July 6 or 7, 1982, not at our suggestion, our clients came to us and said we only want to put most of our money in insured savings and loans or insured deposits in banks.

Senator GORTON. Because of Penn Square?

Mr. GOLDSMITH. Exactly. Having said that, since that time many of our clients because of their size cannot place and spread their deposits in totally insured amounts. I would say today we've gone back to about 20 to 30 percent of all of our deposits are uninsured, because many of our institutional clients are looking at our analysis and then further doing their own analysis and then we use Sears Savings Bank, as a case in point, for some of our uninsured deposits.

Senator GORTON. Mr. Coloma, you said you could not get along without insurance.

Mr. COLOMA. Yes, sir.

Senator GORTON. But that really doesn't answer the question that we have. Why should institutional investors be eligible for insurance?

Mr. COLOMA. The reason of the existence of our company, the creation of our company, was to create a service to provide to small- and medium-sized financial institutions the opportunity to invest their excess liquidity through a system that would insure their deposits so that they would not be involved in any losses in a bank failure. If the insurance system were not to exist, then we would then go to the next available product to sell to our investors as a means to invest their liquidity, but we couldn't sell the CD's of small- or medium-sized banks and savings and loans throughout the country without the Federal insurance.

Senator GORTON. I want to thank each of you for really helping to enlighten us on this subject. I think several members, including the chairman, may have some additional questions which they will submit to you in writing and we will appreciate your cooperation.

The hearing is adjourned.

[Whereupon at 12 noon the hearing was adjourned.]

[Response to written questions of Senator Dodd and additional material received for the record follow:]

FDIC FEDERAL DEPOSIT INSURANCE CORPORATION, Washington, D.C. 20429

OFFICE OF DIRECTOR • DIVISION OF BANK SUPERVISION

October 4, 1985

Honorable Slade Gorton
Chairman
Subcommittee on Financial
  Institutions and Consumer Affairs
Committee on Banking, Housing,
  and Urban Affairs
535 Dirksen Senate Office Building
Washington, D. C. 20510

Dear Mr. Chairman:

This is in response to your letter of September 13 requesting answers to two questions Senator Dodd indicated that he had for Chairman Isaac at the June 5 hearing of the Subcommittee on Financial Institutions and Consumer Affairs. Senator Dodd would like the following questions answered:

1. I understand your concerns about the large amounts of brokered deposits in failing institutions and agree with your point that the investors do not have to worry about safety and soundness because of the deposit insurance. At the same time, you have been a great supporter of deregulation. It seems to me that your opposition to brokered funds is inconsistent with your support for enabling consumers to get the best deal for their money in the marketplace.

   Under the circumstances, do you think a better answer to restrictions on brokered deposits might lie with the use of risk related insurance premiums or other supervisory actions?

2. In the testimony of Jorge Coloma, he describes a proposal for addressing the issue that he says he has been discussing with the FDIC, among others. What do you think of Mr. Coloma's proposal?

With regard to Senator Dodd's first question, we do not at all see our opposition to fully insured brokered deposits as being inconsistent with support for deposit interest rate deregulation. Certainly, consumers should be able to receive market rates for their deposits. However, the pursuit of market rates cannot be viewed in isolation or regarded as the dispositive consideration in all circumstances. When consumers behave as investors and solicit the aid of brokers to shop the country for the highest available risk free yields, which not coincidentally are usually offered by high risk banks and thrifts, other considerations come into play as well. These include questions concerning the fundamental purposes of deposit insurance, the safety and stability of the banking system and the additional losses and threat posed to the deposit insurance fund. All these considerations argue strongly for curtailing the abusive use of fully insured brokered deposits. In short, the existence of a full federal guarantee on many brokered deposits interferes with the normal operation of the marketplace and enables institutions that would be unable to attract such funds, based on their own creditworthiness, to obtain the funds in virtually unlimited amounts.

Insofar as relying on risk related insurance premiums or other supervisory means for controlling abuses are concerned, we regard these as palliatives at best. Certainly, risk related insurance premiums are desirable in their own right as a fairer means of allocating the cost of deposit insurance and as a means of constraining excessive risk taking. However, risk related premiums do not target the abusive use of brokered deposits and fail completely to address the fundamental abuse of the deposit insurance system represented by money market investment decisions predicated exclusively on the existence of a full federal insurance guarantee rather than on a proper credit analysis of the bank or thrift borrowing the funds.

Supervisory means of controlling abuses are simply not adequate to the task. Of necessity, they are initiated after the fact when problems and clear abuse have been identified. In the absence of a regulatory or legislative solution, however, we have vigorously pursued our supervisory options. For example, for nearly two years now we have routinely inserted a provision in all enforcement actions taken against troubled banks prohibiting further use of brokered deposits. In January of this year, the FDIC instituted a monthly reporting requirement for all FDIC-insured banks and thrifts holding fully insured brokered and financial institution deposits in excess of either the institution's capital or five percent of its deposits. Institutions reporting heavy use of brokered funds are targeted for much more frequent inspections, as are those that show up on deposit listing services as paying above normal interest rates. We recently began publicly disclosing the names of financial institutions placing funds in failed banks and thrifts. Our aim here is to focus attention on the fact that when brokered and financial institution deposits are placed in institutions offering the highest rates without regard for their condition, the cost to the deposit insurance fund is greatly increased. All these measures have helped but, in an environment in which a bank or thrift may purchase a massive volume of funding overnight and radically alter the character of its risk to the insurance fund, they tend to be too little too late.

With regard to Senator Dodd's second question, Mr. Coloma has proposed in his prepared testimony that:

° a cap of 20 percent of deposits be placed on insured brokered deposits at any depository institution meeting minimum net worth requirements;

- insured brokered deposits be prohibited to any depository institution failing to meet minimum net worth requirements, as determined by the regulators;
- a depository institution be restricted from having from any one deposit broker more than 25 percent of its maximum allowed insured brokered deposits maturing in any one three-month period; and
- deposit brokers report to the Federal regulators key information about brokered deposits that will help the regulators anticipate and limit potential imprudent uses of those funds by the management of insured depository institutions.

While not the approach we would prefer, we can accept a cap provided it is reasonable. Twenty percent of deposits, however, is clearly excessive. We do not believe an institution should be able to leverage upon the federal insurance guarantee with insured brokered deposits in a volume greater than that which its owners have at risk. Thus, the cap for insured brokered deposits should be limited to no more than 100 percent of an institution's capital.

Similarly, a prohibition against any insured brokered deposits at a depository institution failing to meet minimum net worth requirements would be helpful, provided however, the law does not impinge in any way on our current authority to prohibit the use of brokered funds by any troubled bank or thrift.

Sincerely,

Robert V. Shumway
Director

Federal Home Loan Bank Board

1700 G Street N.W.
Washington, D.C. 20552
Federal Home Loan Bank System
Federal Home Loan Mortgage Corporation
Federal Savings and Loan Insurance Corporation

EDWIN J. GRAY
CHAIRMAN

October 15, 1985

Honorable Slade Gorton
Chairman
Subcommittee on Financial
Institutions & Consumer Affairs
Committee on Banking, Housing
and Urban Affairs
Washington, D.C. 20510

Dear Senator Gorton:

This is in response to your September 13 letter requesting answers to additional questions raised by Senator Dodd regarding your Subcommittee's hearing of June 5 on brokered deposits.

Question No. 1

"In your testimony, you suggest a 5% of total insured deposits limit on brokered funds. How would that cap compare with Chairman Isaac's recommendation of a limit of 100% of capital?"

Bank Board Response:

In numerical terms both of these proposals are similar. As of July 1985, the average regulatory net worth of FSLIC-insured institutions was approximately 4.4%. My suggestion of a cap of 5% of total insured deposits on brokered funds would equal approximately 4.2% of total liabilities, which is similar to the FDIC's proposal of using capital as a base.

Question No. 2

"What would be the difference in exposure to the FSLIC between your recommendation of 5% and the D'Amato bill's limit of 15%?"

Bank Board Response:

Under S. 791, introduced by Senator D'Amato, institutions would be prohibited from receiving short-term brokered deposits (generally those maturing in less than one year) in excess of the lesser of 200% of its capital or 15% of its total deposits.

Under the 200% of capital formula, brokered deposits would equal $88 billion in exposure to the FSLIC, or 8.8% of the total liabilities of FSLIC-insured institutions (This number assumes average regulatory net worth of 4.4%). The 15% cap formula would increase the FSLIC's exposure to $123 billion. However, both formulas would still exceed my suggestion of 5% of total deposits, or $42 billion in exposure to the FSLIC, which is significantly less than either of the formulas in S. 791.

In addition, under S. 791, institutions that are unable to comply with the minimum net worth requirement would be prohibited from accepting brokered deposits. Since 30 percent of the total thrift industry liabilities are in institutions that are unable to meet the minimum net worth requirement of the Bank Board, this requirement would reduce the exposure to the FSLIC from $88 billion to $62 billion. Clearly, the exposure to the FSLIC is greater under the D'Amato bill than my recommendation.

Question No. 3

"What do you think of Mr. Jorge Coloma's [President of FAIC Securities, Inc.] proposal?"

Bank Board Response:

Under the FAIC proposal, brokered deposits would be permitted up to 20% of total deposits for an institution meeting its minimum net worth requirement. Institutions not meeting this requirement would not be permitted to maintain brokered deposits. Not more than 25% of the maximum permitted brokered deposits could mature in any three-month period.

Allowing brokered deposits up to a maximum of 20% of total deposits would not be an effective solution as it would permit most institutions with growth of 10% or less to raise all new deposits from brokers for two or three years. Although this proposal limits 25% of the maximum amount to mature in any three-month period, it would still permit total withdrawal in one year, which does not solve the volatility problem of these types of deposits.

Please feel free to call upon me or my staff if you have any additional questions.

Sincerely,

Edwin J. Gray

Comptroller of the Currency
Administrator of National Banks

Washington, D.C. 20219

September 24, 1985

The Honorable Slade Gorton
Chairman
Subcommittee on Financial Institutions
and Consumer Affairs
Committee on Banking, Housing
and Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Senator Gorton:

This letter is in response to your request for OCC's views on brokered deposits to supplement information the Subcommittee on Financial Institutions and Consumer Affairs received at its June 5, 1985 hearing.

The OCC believes that deposit brokering performs a valuable economic function for depositors and financial institutions and that we can continue to deal effectively with the supervisory concerns raised by brokered deposits by imposing certain limitations and restrictions on a case-by-case basis where necessary. However, we recognize that Congressional action may be needed to address the problems that brokered deposits pose to the federal deposit insurance system.

Benefits of Brokered Deposits

Deposit brokering provides important benefits to savers, depository institutions, and the economy as a whole. Consumers can buy certificates of deposit (CDs) issued by banks or thrift institutions anywhere in the country through a deposit broker. Individual savers can more conveniently shop for the interest rate, denomination, and maturity that they want. Moreover, many deposit brokers provide an additional source of liquidity by making a secondary market in CDs. In these cases, small savers can sell their CDs back to their brokers without paying early withdrawal penalties, while banks continue to have the use of long-term funds. It is a situation where both the consumer and depository institution win.

Deposit brokering can be an efficient means for banks and thrift institutions to attract deposits. Brokered deposits may represent an inexpensive means to attract deposits. For most institutions, deposit brokering provides more flexibility in matching assets and liabilities than is possible with funds acquired through a branch system. It makes it easier for institutions to acquire long-term deposits and gives small institutions access to regional and national markets. Finally, deposit brokering facilitates the flow of funds from communities that have a capital surplus to other markets where funds are scarce.

In spite of the benefits, the use of brokered deposits within the national banking system is far from pervasive. In fact, only about 6 percent of all national banks receive brokered deposits, and these deposits constitute less than 1 1/2 percent of all national bank deposits. Furthermore, the vast majority of national banks with brokered deposits receive less than 10 percent of their deposits from this source and are sound, well-run institutions.

Supervisory Concerns

While use of brokered deposits by national banks is quite limited, there are clearly legitimate concerns regarding the placement by brokers of large deposits into fully insured accounts at several banks. First, this activity could hasten the deterioration of a distressed or poorly managed institution. Second, it minimizes market discipline while increasing the exposure of the insurance funds.

The ability of a bank to obtain insured funds quickly can, in some cases, present serious supervisory problems. For example, when a bank experiencing liquidity problems can turn to brokered funds rather than borrow from its Federal Reserve Bank, supervisory detection of problems is hampered. Moreover, the use of brokered funds can enable a bank to undergo sudden, rapid growth. Whether this is a problem, of course, depends not on the fact that the funds came from deposit brokers but on how the funds are put to use. If a bank is imprudently managed, sudden growth may reflect increased risk.

Although these supervisory problems are not insignificant, the Office has adequate authority to deal with them. First, we routinely look at the use of brokered deposits as part of our normal bank examinations. Banks are also subject to minimum capital standards that limit the ability of a bank to undergo rapid growth, thereby indirectly restricting the imprudent use of brokered deposits. Currently, we are studying the feasibility of a risk-based capital requirement that would more appropriately control growth by assigning a minimal capital requirement based on the overall riskiness of a bank's activities.

Finally, we have procedures in place to make sure that brokered deposits are not used to turn small problem banks into big problem banks overnight. We can apply restrictions and limitations on brokered deposits on a case-by-case basis ranging from a simple requirement to report the use of brokered deposits to a total prohibition. We have found this approach to be highly effective. Currently, only about 20 percent of national banks on our problem bank list have any brokered deposits.

FDIC Liability and Market Discipline

The supervisory issues raised by deposit brokering are not unique and can be dealt with by the agencies under their existing regulatory authority. However, the increased use of brokered funds to provide full insurance coverage for large deposits raises two other problems.

First, the exposure of the federal deposit insurance fund is increased. This is particularly true when these fully insured brokered funds flow to institutions in a weakened financial condition that are paying higher interest rates.

Second, when large depositors can obtain full insurance coverage through deposit brokering, the banks issuing the CDs are not subjected to the market discipline that might otherwise be provided by such large depositors. When depositors can place funds with institutions solely on the basis of yield without regard to the riskiness of the institutions, bank managers escape the scrutiny of the marketplace. This puts an increased burden on the regulators to limit risk-taking by banks and hinders the achievement of an important public policy goal: increased market discipline.

Many proposals have been put forth to address the problems raised by the brokering of insured retail deposits. The approach of most of them is to place various limitations on institutions' use of brokered funds. In our view, this approach only addresses a symptom, while ignoring the more fundamental cause of the problem.

Needed Reforms

Reforms are needed to deal with the reduced market discipline and concomitant heightened exposure of the insurance funds that are brought about by large depositors splitting their funds into fully-insured increments. We propose three measures to enhance market discipline of banks and reduce the occurrence of deposit brokering that is motivated solely by the desire to obtain full deposit insurance on large deposits.

First, public disclosure of information on the financial condition of banks and thrift institutions should be increased. We will soon issue a proposed rule that will require such increased disclosure. Greater disclosure would permit depositors to better assess the risk involved in depositing funds in a given bank or thrift. Until depositors have enough information to differentiate between well-run and poorly-managed institutions, we cannot expect market discipline to help solve this problem.

Second, Congress should enact much-needed reform of the deposit insurance system itself. There are a number of possibilities that could be considered. Most importantly, the FDIC and the FHLBB should be empowered to develop mechanisms to make certain that uninsured depositors experience some degree of loss when a bank fails.

Last, we ask Congress to consider limiting the insurance coverage of a depositor on funds placed through any single broker to $100,000. That would preserve the benefits of deposit brokering to small savers while making it impossible for large and presumably more sophisticated investors to use brokers to split their funds into insured lots. It would also allow depository institutions to continue to use brokers to gather small retail deposits.

Together, these changes would enlist the discipline of large depositors to supplement that provided by the regulators. Depositors would still be able to use deposit brokers to diversify their risk. Small depositors would not be affected by these changes, and could still obtain insured deposits either directly or through a broker. Finally, these changes would mean that those who reap the rewards of high interest rates would also bear the risks, instead of having the risk of failure shifted to the insurance funds. The result would be that market discipline would play a more fundamental role in assuring the safety and soundness of the banking system.

Sincerely,

Michael A. Mancusi

Michael A. Mancusi
Acting Comptroller of the Currency